

## From Risk Profiling to Investment Suitability

### *A needs-based approach to pension and retirement planning*

A combination of continued low yields, pressure on defined-benefit pension schemes to manage liabilities, and the introduction of auto-enrolment, mean that advisors face complex retirement planning decisions which will have a direct and dramatic impact on their clients' pension benefits.

This financial planning challenge needs to be viewed against a rapidly evolving regulatory backdrop:

- The FSA's recent consultation on pension transfer value analysis (PS 12/8)<sup>1</sup> has resulted in changes to COBS 19 which raise critical questions regarding the existing pension transfer advice process:

**19.1.7A G** When giving a personal recommendation about a pension transfer, a firm should clearly inform the retail client about the loss of the fixed benefits and the consequent transfer of risk from the defined benefits pension scheme to the retail client, including:

(1) **the extent to which benefits may fall short** of replicating those in the defined benefits pension scheme...

**19.1.7b G** In considering whether to make a personal recommendation, a firm should not regard a rate of return which may replicate the benefits being given up from the defined benefits pension scheme as sufficient in itself.

The result of this new guidance should significantly raise the 'suitability' bar required to recommend a pension transfer.

- Following from CP 12/10, the FSA appears likely to reduce maximum growth rate assumptions for statutory pension illustrations<sup>2</sup>; consequently advisors may have to explain to clients why projected pensions have fallen by over 25%.

Prescribing this significant change in the rates of return after three years of falling yields and economic turmoil will paper over the cracks of an illustration framework which continues to fail both advisors and investors.

### Investment proposition and advice process: evolving best practice

In our previous article, "From Risk Profiling to Investment Suitability: the Building Blocks of a Best Practice Investment Proposition", we considered the FSA's 2011 guidance on Investment Suitability<sup>3</sup> and assessed the impact this has had on the evolution of retail investment propositions and advice.

We identified three building blocks which are being put in place to enhance existing retail investment and advice propositions:

- A client needs analysis which captures: attitude to risk, financial goals, and capacity for loss.
- A range of risk-based (or risk-graded) investment options aligned with clearly defined and quantified risk targets, which reflect the needs of defined customer segments: investment term, capital accumulation or income, etc.
- Stochastic modelling tools allow advisors to project investment outcomes for different investment options and quantify potential loss in relation to the client's specific financial goals:
  - How likely am I to achieve my goal?
  - If things don't go well, what is the size of the potential shortfall?

1. <http://www.fsa.gov.uk/static/pubs/policy/ps12-08.pdf>

2. <http://www.fwww.fsa.gov.uk/static/pubs/cp/cp12-10.pdf>

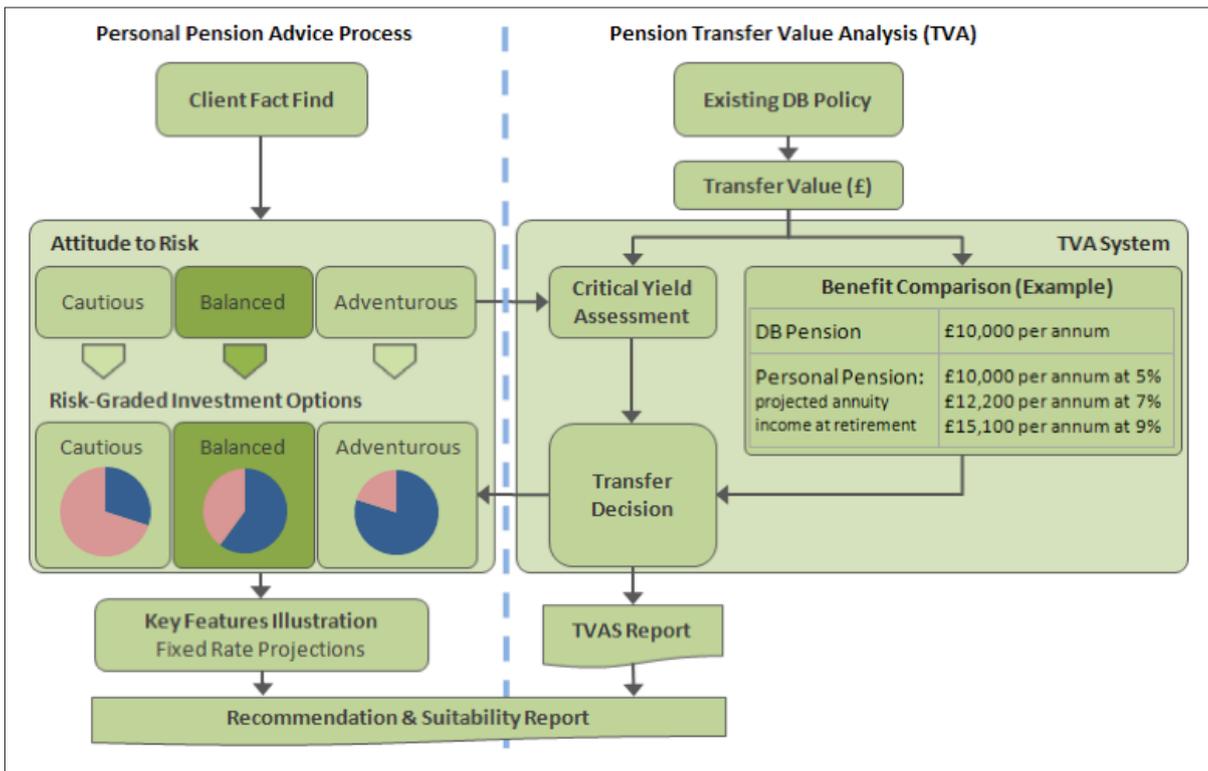
3. [http://www.fsa.gov.uk/static/pubs/guidance/fg11\\_05.pdf](http://www.fsa.gov.uk/static/pubs/guidance/fg11_05.pdf)

These modelling outputs provide a completely objective basis to align investment options with the client's personal financial goal, and to document the suitability of the recommendation.

Not surprisingly, the current regulatory review of pensions<sup>1</sup> has identified similar gaps in the existing process for personal pension investment advice and pension transfer.

Fortunately for firms who are working to put in place the above building blocks within their own investment advice proposition, there is a natural and straightforward extension of these to support personal pension planning.

## Existing framework for pensions investment advice



The following exhibit illustrates a typical process for providing investment advice to personal pension clients, including those considering transfer from an existing defined benefits scheme:

## Existing pensions advice framework: gap analysis

While the FSA suitability guidance focused on investment rather than pensions, many of the issues raised reflect similar weaknesses in this existing framework for personal pensions investment advice:

- The above framework does not account for investment risk (volatility). Decisions are based on the assumption that the 'worst' return is given by a (fixed) lower rate of return. Regardless of the FSA's current review of the 'maximum' growth rates, any deterministic assumption like this will represent a dramatically over-optimistic view of the real world, and mean decisions fail to capture the client's capacity for loss.
- The FSA consultation on Pension TVA assumptions states that the Transfer Decision is often too reliant on a comparison of the client's "attitude to risk" with the calculated Critical Yield. This process is subjective, does not capture or explain the risk of failing to achieve the Critical Yield, and fails to illustrate the potential size of any shortfall in future pension income.
- If the decision is taken to transfer into a personal pension plan, there is nothing in the above process which allows the advisor to align the choice of investment option with the client's specific financial goals, or with their tolerance for loss in relation to these goals:
  - Required income in retirement
  - Access to capital (e.g. to support healthcare, one-off expenses, bequest planning)

These gaps in the investment process reflect a need to more explicitly quantify the risk in personal pension investment, particularly when

compared against an existing defined-benefit 'promise'. It is very difficult to manage risk in line with a client's personal objectives if the risk cannot be quantified.

### Pension investment advice: filling the gaps

At the core of the pension investment challenge lie two complex elements of advice that require advisors to demonstrate suitability for each individual client:

1. Pension Transfer Decision: Should I accept the transfer value being offered?
2. Personal Pension Investment Option Selection: Given my client's current personal pension savings and any planned future contributions, what is the most suitable investment option, given my client's attitude to risk, financial goals, and capacity for loss?

Fortunately, the building blocks being put in place by advisors, supported by Moody's Analytics risk modelling capability will also deliver the objective analysis required to support these critical pension decisions.

Needs Analysis: Financial Goals	Pension Transfer Decision: Suitability Process
<p>Personal pension planning goals:</p> <ul style="list-style-type: none"> <li>• Existing DB income amount</li> <li>• Required retirement income amount</li> <li>• Need for access to capital/liquidity</li> </ul> <p>Example:            "I'd like my pension pot to generate an income of around £10,000 pa"            "I'd like to be able to retain access to at least £50,000 of capital to support long-term care, or to leave to my dependants as a bequest."</p>	<p>Is the existing DB income 'promise' significantly higher (or lower) than the required retirement income?</p> <p>Does the client require greater liquidity than would be possible under the existing DB scheme?</p> <p>To support a more realistic benefits comparison, the modelling tool can be used to project the pension income benefit under the personal pension, based on a low risk investment strategy that reflects the risk transfer to the client (e.g. govt. bonds and/or cash).</p> <p>This allows the advisor to confirm that the client can generate the DB benefit on a low-risk or no-risk basis.</p>

### Personal pension investment option selection

Traditionally, the selection of an investment option has been focused on an assessment of a client's "attitude to risk", but this has not provided a mechanism for aligning the investment recommendation with the client's financial goals, or their capacity for loss.

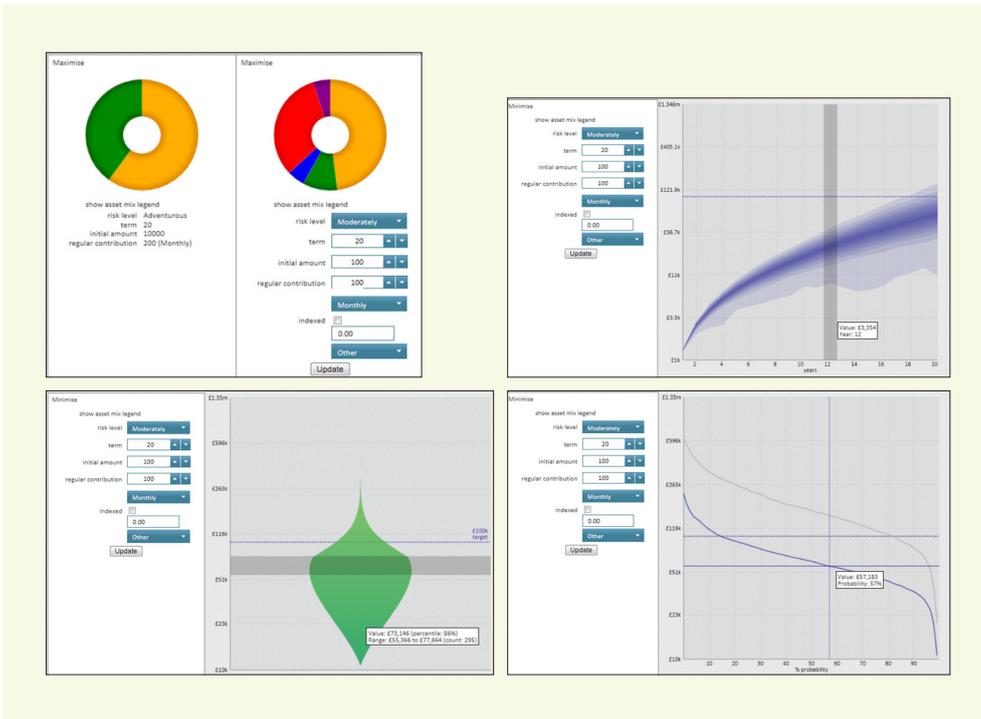
Risk modelling (or stochastic projection) tools now allow advisors to understand and communicate the implications of each investment option, in terms of outcomes in relation to the client's personal financial goal:

Needs Analysis: Financial Goals	Matching Investment Option to Financial Goal
<p>Personal pension planning goals:</p> <ul style="list-style-type: none"> <li>▪ Required retirement income amount</li> <li>▪ Need for access to capital/liquidity</li> </ul> <p>Example:            "I'd like my pension pot to generate an income of around £10,000 pa"            "I want to be able to retain access to at least £50,000 of capital to support long-term care, or to leave to my dependants as a bequest."</p>	<ul style="list-style-type: none"> <li>▪ Calculate the probability that the recommended investment option achieves the client's specific financial goals:                "There is a 68% chance that the recommended investment option achieves your financial goals"</li> <li>▪ Identify the investment option which maximizes the chance of achieving the target income level:                "By reducing the level of risk (and return) you can increase this to 90%"</li> <li>▪ Identify the contribution level required to secure the financial goals (with high probability):                "By increasing your contribution rate from £100 to £140 pcm, you can increase the chance of meeting your goals to 90%"</li> </ul>
<p>The client's ability to accept any outcome that does not meet their investment objectives in full.            "While £10,000 is the income I need to achieve my preferred lifestyle, I can accept some risk that the income could be lower than this."</p>	<ul style="list-style-type: none"> <li>▪ Calculate the risk of shortfall, relative to the target minimum income level or fund value:                "Under the recommended investment option, there is a 9% chance that the income level could fall below your minimum of £7,500 pa."</li> </ul>
<p>The extent of loss that the client could accept in relation to their investment objectives.            "While I can accept some risk, I would not want my retirement income level to fall below £7,500 pa."</p>	<ul style="list-style-type: none"> <li>▪ Calculate the size of potential shortfall:                "If your investments performed badly, there is a 1 in 20 (5%) chance your income level could fall below £7,100 pa."</li> </ul> <p>Identifying the investment option which minimizes the risk of shortfall:            "By selecting a lower risk investment option, you can reduce the risk of your income falling below £7,500 to less than 5% (1 in 20)."</p>

## Stochastic modelling of pension income outcomes against client goals: Example analysis

The exhibit below provides some examples of the modelling of outcomes against a client's specific financial goal. In general, this modelling capability enables an advisor to:

- Explain the likelihood the client will achieve their specified goals, for any selected investment option
- Illustrate the potential downside, or shortfall, relative to the financial goal
- Identify the investment option which best aligns with the client's goal and capacity for loss
- Understand how contribution level can be adjusted to ensure a higher chance of achieving the goal
- Illustrate the range of likely outcomes, providing a more realistic basis to manage the client's investment plan as they near retirement



As well as aligning their proposition with FSA guidance, financial modelling tools enable firms to deliver pensions advice which is objectively matched to client needs, and put in place an efficient review service designed to keep their client's plans on track.

Moody's Analytics modelling is used to power a range of advisor financial planning tools.

*This article was written by Philip Mowbray, Senior Director, Product Management at Moody's Analytics. It was first published in Capita Connections*

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