NEWS REGULATION

FCA: Industry does not understand capacity for loss

By Tessa Norman 20th November 2014 9:51 am

Many advisers do not understand what capacity for loss means and should rely on their own calculations rather than clients' "emotional" responses, says the FCA.

Speaking at an Open University Business School conference in London yesterday, FCA technical specialist Rory Percival said some advisers still confuse capacity for loss with risk profiling.

He said: "One concern we have is that I personally have some conversations with people in the industry and I get the impression they don't quite get what capacity for loss is. They start to talk about clients' emotional reactions to losses and sound more like they are referring to the client's risk profile rather than capacity for loss."

Percival said in many respects capacity for loss is something the adviser can work out, rather than the client coming to their own conclusion.

He said: "One of the concerns we have about capacity for loss is that the way some firms approach this is to ask the client: how much can you afford to lose before it has a material impact on your standard of living?

"Our concern would be that that might be the right question, but are you getting the right answer? I suspect in the majority of cases there is the risk the client might give an emotional answer, rather than the hard-nosed numbers point that capacity for loss is really getting at."

Percival said advisers can assess capacity for loss through a number of methods, including lifetime cash flow analysis, although he acknowledged this is "expensive" and not suitable for all clients.

He said: "For other clients it is about really having an understanding of what their income and outgoings are both now and in the future."

Percival said while advisers have improved their approach to capacity for loss since the regulator first warned about risk profiling tools in January 2011, it is still an area where the industry "is developing what good practice looks like".

He added that the FCA continues to find problems on a regular basis around risk descriptions.

He said: "Some of the descriptions include jargon, and quite often vague language. They rarely provide any quantification or differentiation of risk.

"So there are references like 'you are prepared to take some risk' – that is not really putting the client in the position where they can understand the risk of the solution that is recommended to them."

Percival said some advisers are still focusing solely on the client's risk profile and simply mapping their risk rating to a fund without taking into account factors such as capacity for loss and term.

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