Finalised guidance

Assessing suitability:

Establishing the risk a customer is willing and able to take and making a suitable investment selection

March 2011

Financial Services Authority

Contents

1 Overview

1.1 The high number of unsuitable investment selections[1] we see in the pensions and investment markets is still a significant concern, as highlighted in the Financial Risk Outlook Retail Intermediaries Sector Digest 2010.[2] It is a specific risk to our consumer protection objective.

1.2 The Conduct of Business sourcebook (COBS) 9.2.1R requires a firm to take reasonable steps to ensure that a personal recommendation, or decision to trade, is suitable for its customer. COBS 9.2.2R requires firms, among other things, to take account of a customer's preferences regarding risk taking, their risk profile and ensure they are able financially to bear any related investment risks consistent with their investment objectives. We use the expression 'the risk a customer is willing and able to take' in this report as a shorthand description of these elements of COBS 9.2.2.R.

1.3 Of the investment files assessed as unsuitable between March 2008 and September 2010, we rated half of these as unsuitable on the grounds that the investment selection failed to meet the risk a customer is willing and able to take.

1.4 The level of failure in this area is unacceptable. We have taken, and continue to take, tough action to address these failings with individual firms.

1.5 Prompted by these results and our ongoing concerns in this area, and to help firms and trade bodies to tackle the issues this report considers:

- how firms establish and check the level of investment risk that retail customers are willing and able to take (in the wider context of the overall suitability assessment);
- the potential causes of failures to provide investment selections that meet the risk a customer is willing and able to take; and
- the role played by risk-profiling and asset-allocation tools, as well as the providers of these tools.

1.6 This report is relevant to firms providing investment advice or discretionary management services to retail customers. It is also relevant to providers of risk-profiling and asset-allocation tools, including those provided as part of a platform. We do not prescribe **how** firms establish the risk a customer is willing and able to take, or how they make investment selections, accepting that firms should give due consideration to the nature and extent of the service provided. We have seen an increasing trend of firms adopting risk-profiling and asset-allocation tools to support, supplement or replace aspects of more traditional 'know your customer' approaches. Our review highlights the risks and weaknesses of different approaches whether or not firms use tools.

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[1] We use the term 'investment selection' to represent both advisory services (recommendations) and transactions undertaken by private client discretionary wealth managers.

[2] http://www.fsa.gov.uk/pubs/plan/sdg_ri.pdf

Structure of the report

1.7 This Chapter provides a high-level summary of our key concerns and risks. The rest of this report details our findings and includes examples of good and poor practice demonstrated by firms against which other firms can judge their own processes and identify areas where they can improve:

- Chapter 2 explains the scope of the review and our methodology.
- Chapter 3 considers how firms are establishing the risk a customer is willing and able to take, including the impact of risk-profiling tools and the risk category descriptions that firms use.
- Chapter 4 considers how firms make investment selections which reflect the needs and circumstances of customers (particularly the risk they are willing and able to take), including the use of asset-allocation tools.
- Chapter 5 considers the role provided by third-party tool providers and the issues firms adopting tools need to consider.

Key findings

Failure to collect and properly account for all the information relevant to assessing the risk a customer is willing and able to take

1.8 We have identified common approaches that can lead to an inadequate assessment of the risk a customer is willing and able to take:

- Although most advisers and investment managers consider a customer's attitude to risk when assessing suitability, many fail to take appropriate account of their capacity for loss.[3]
- Where firms use a questionnaire to collect information from customers, we are concerned that these often use poor question and answer options, have over-sensitive scoring or attribute inappropriate weighting to answers. Such flaws can result in inappropriate conflation or interpretation of customer responses.
- We have seen examples of firms failing to have a robust process to identify customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital.[4]

1.9 These findings are detailed in Chapter 3.

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3 By 'capacity for loss' we refer to the customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take.

4 Recognising the risks that inflation can erode the value of capital.

Relying on risk-profiling and asset-allocation tools

1.10 Tools can usefully aid discussions with customers, by helping to provide structure and promote consistency. But they often have limitations which mean there are circumstances in which they may produce flawed results. Where firms rely on tools they need to ensure they are actively mitigating any limitations through the suitability assessment and 'know your customer' process (see Chapters 3 and 4).

1.11 We reviewed 11 risk-profiling tools[5] and were concerned to find that nine tools had weaknesses which could, in certain circumstances, lead to flawed outputs. Similar weaknesses are identifiable in non-tool approaches (see Chapter 3).

Poor descriptions of attitudes to risk

1.12 Generally, firms divide the investment-risk spectrum into different categories. Descriptions are often associated with these categories to aid customer understanding and enable a firm to check that they have correctly identified the risk the customer is willing and able to take. We have found many examples of descriptions that are not fit for purpose: they are vague and do not effectively explain or differentiate levels of risk (see Chapter 3).

Failing to select suitable investments for the customer

1.13 Even where the risk profile of the customer is correctly assessed, the product or portfolio (and underlying asset-allocation) does not always match this profile. This can be due to a failure to select investments that match the risk a customer is willing and able to take or a failure to take account of all aspects of a customer's investment objectives and financial situation (see Chapter 4).

Inappropriate focus on the risk a customer is willing to take

1.14 Some firms unduly focus on the risk a customer is willing to take and fail to take sufficient account of the customer's other needs, objectives and circumstances: for example failing to consider whether the customer would be better placed repaying debt, or failing to select an investment that meets a customer's need for access or the term for which the customer wishes to invest. While attitude to risk is an important consideration, suitability is not just about making investment selections that reflect a customer's attitude to risk.

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5 We use the term 'risk-profiling tools' in a broad sense reflecting industry practice. We refer to different structured methodologies, ranging in degree of automation and scope. This includes tools designed 'in-house' and those provided by third parties including those provided as part of a platform service.

Understanding products and underlying assets

1.15 Another component of the risk analysis is to consider the relative risk of an asset or product. We have seen many cases where firms demonstrate a failure to understand the nature and risks of products or assets selected for customers.

1.16 Firms should satisfy themselves that, at the time they select investments for customers, they have reasonably considered what risks could be associated with the investment and that they understand these (see Chapter 4).

Responsibilities when using tools

1.17 We are also concerned that our findings suggest many firms do not understand how the tools they use work, including what they are (and are not) designed to do. Firms should use a tool only where they are satisfied that it provides outputs that are appropriate and fit for purpose. Firms need to recognise where a tool has limitations and mitigate these in the suitability assessment process.

1.18 Firms remain responsible for assessing suitability, including assessing the risk a customer is willing and able to take, even when using tools. Tool providers have a role to provide clear supporting information to firms that will use the tools, to help them use them as designed (see Chapter 5).

Next steps

1.19 This report provides examples of our concerns which, if not mitigated, could result in poor outcomes for customers. We have also provided examples of good practice to help firms reduce the risk of making unsuitable investment selections. The examples of good and poor practice have been compiled in a way that avoids identifying individual firms.

1.20 We expect all types of firms to consider whether they need to improve the way they assess and check the risk a customer is willing and able to take and so ensure they make suitable investment selections. We encourage providers of risk-profiling and asset-allocation tools to take action to address any potential weaknesses in their tools.

1.21 As we apply our intrusive and intensive supervisory approach, we will be looking to see how firms have acted on this report. We will consider, for example, whether firms have robust procedures, tools and risk category descriptions (where used) to establish and check the level of risk a customer is willing and able to take, as well as assessing the suitability of investment selections.

1.22 We expect to see improvements in the standards of advice and private client discretionary management, and will continue to take tough action where we identify poor practice.

Firms should ensure that, in particular:

- they have a robust process for assessing the risk a customer is willing and able to take, including:
  - assessing a customer's capacity for loss;
  - identifying customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital;
  - appropriately interpreting customer responses to questions and not attributing inappropriate weight to certain answers;
- tools, where used, are fit for purpose and any limitations recognised and mitigated;
- any questions and answers that are used to establish the risk a customer is willing and able to take, and descriptions used to check this, are fair, clear and not misleading;
- they have a robust and flexible process for ensuring investment selections are suitable given a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience;
- they understand the nature and risks of products or assets selected for customers; and
- they engage customers in a suitability assessment process (including risk-profiling) which acts in the best interests of those customers.

2 Our approach

Scope

2.1 Our review focused on the following key areas:

- whether methodologies for assessing the risk that a customer is willing and able to take with their money are fit for purpose, including the use of risk-profiling tools;
- whether descriptions firms use to reflect and check the level of risk a customer is assessed as being willing and able to take are fair, clear and not misleading; and
- whether processes for choosing investments result in selections which are suitable for the risk a customer is willing and able to take, including the use of asset-allocation tools.

2.2 Third-party tool providers can play an important role in helping customer-facing firms provide suitable outcomes for their customers. Nevertheless, where third-party tools are used, the adviser or discretionary manager remains responsible for assessing suitability.

2.3 The focus of our work reflects our more intensive supervisory approach as articulated in our conduct strategy, and contributes to the meeting of our consumer protection objective. It is consistent with and builds on previous information we have published on matching a financial product to a retail customer's needs.[6]

Methodology

2.4 We reviewed the causes relating to suitability assessment failings from files previously reviewed by the FSA between March 2008 and September 2010. Of the 366 cases that we judged to have failed our suitability requirements, 199 cases did so because the investment selection did not meet the customer's 'attitude to risk'.[7]

2.5 Firms in this sample used a range of methodologies (including tools) to establish a customer's 'attitude to risk'. The scope of the review included cases reviewed as part of thematic work[8] as well as those reviewed as part of our day-to-day supervisory work, including investment advice provided by individual firms and services provided by discretionary management firms.

2.6 We also reviewed the use of risk-profiling and asset-allocation methodologies, including tools, by requesting information, and meeting with a range of firms. This sample covered the following sectors: banking, insurance, independent financial advisers, discretionary and advisory investment managers, networks, platform providers and third-party tool providers.

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6 http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/practice/risk.shtml

7 These figures are not necessarily indicative of the quality of discretionary management or pensions and investments advice in the market as a whole; the files reviewed were indicative samples and in some cases we were focusing on higher risk firms.

8 Including thematic reviews relating to Lehman-backed structured products, investment advice using platforms and pension switching.

Limitations to our approach

2.7 We have identified risks and collected examples of good and poor practice, but this report does not make judgements on the overall effectiveness of controls in individual firms because we have not necessarily tested outcomes and tools in the same firms. We have informed ourselves of the approaches firms are taking and assessed the risks inherent in these approaches, given our broad intelligence base from file reviews.

2.8 We focused on the outcomes from firm processes, including the results from tools, in light of possible customer scenarios. We did not review the assumptions used in asset-allocation tools, nor did we review the underlying academic basis of psychometric approaches in risk-profiling tools.

3 Establishing the risk a customer is willing and able to take

3.1 This Chapter is relevant to advisers and private client discretionary managers. It focuses on how firms that offer investment advice or discretionary management services to retail customers:

- assess the risk a customer is willing and able to take; and
- check with the customer that the firm has correctly identified and understood the risk a customer is willing and able to take.

Key risks for firms to consider

Poor outcomes can occur if firms, in particular:

- fail to collect and account for all the information relevant to assessing the risk a customer is willing **and** able to take as part of suitability considerations, for example because they:
  - fail to assess a customer's capacity for loss;
  - do not have a robust process to identify customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital;
  - use poor questions and answers to establish the risk a customer is willing and able to take;
  - inappropriately interpret customer responses to questions (particularly where firms rely on tools with sensitive scoring or attribute inappropriate weighting to answers); or
- use vague, unclear or misleading descriptions or illustrations to check the risk that a customer is willing and able to take.

Our requirements – assessing suitability

3.2 A firm must take reasonable steps to ensure that a personal recommendation, or decision to trade, is suitable for its customer.[9]

3.3 As part of this, firms must obtain from the customer such information as is necessary to understand the essential facts about them and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

- meets the customer's investment objectives;

[9] COBS 9.2.1R(1)

- is such that the customer is able financially to bear any related investment risks consistent with their investment objectives; and
- is such that the customer has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of their portfolio.

3.4 Information regarding the investment objectives of a customer must include, where relevant, information on the length of time for which they wish to hold the investment, their preferences regarding risk taking, their risk profile, and the purposes of the investment.

3.5 Failure to obtain all the relevant information or evaluate it properly can lead to the recommended transaction or decision to trade being unsuitable for the customer. Overall, firms must ensure that they are acting honestly, fairly and professionally in accordance with the best interests of the customer[10] and treat customers fairly.[11]

Our findings

Assessing the risk a customer is willing and able to take

3.6 Establishing the risk a customer is willing and able to take with their money is a key part of the suitability assessment.[12]

3.7 We do not prescribe how firms must assess the risk a customer is willing and able to take – but firms need to ensure they have a clear and robust process that is fit for purpose.

3.8 In this Chapter we identify potential issues that firms need to consider if they are to reduce the likelihood of poor customer outcomes.

Using risk-profiling tools

3.9 Firms using risk-profiling questionnaires or tools place varying degrees of reliance on the outputs. Where they are used within a suitability assessment process, tools and questionnaires can help to provide structure and promote consistency and so can usefully support the discussion a customer has with their adviser or investment manager.

3.10 However, tools may not provide the right answer in all circumstances. So where firms rely on tools, they need to ensure they consider this risk and actively mitigate any shortcomings or limitations through the suitability assessment and 'know your customer' process.

3.11 If a firm relies on the automated output from a tool, it is important that:

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10 COBS 2.1.1R(1)
11 Principle 6
12 COBS 9.2.2R

- the tool is fit for purpose;
- it is used only in the circumstances, and for the target market, for which it was designed;
- users understand how the tool works and any limitations of the outputs it generates, including to what extent the tool will help them meet their regulatory requirements; and
- the customer is able to understand and engage with the process as designed.

3.12 Nine out of the 11 tools we reviewed had features that meant that there was a high probability that, under certain circumstances, the output might not accurately reflect the risk that a customer is willing or able to take. Similar weaknesses and limitations are identifiable in non-tool approaches. We discuss these and the risks created as a result, under the headings below.

3.13 Chapter 5 sets out our specific concerns and expectations of the role third-party tool providers play in ensuring advisers or private client discretionary managers understand the tools they rely on.

Good practice

A firm produced regular management information on the results of the risk-profiling tool used. It included information on how the results are distributed across the different risk categories and how this compares to what would be expected given the firm's customer base. It also included information on the number of customers whose final risk categorisation is different to that indicated by the tool including information on the numbers that have moved by more than one category. Managers were given guidance about what information they should be considering, including when they should investigate further.

Failing to collect and account for all the information relevant to assessing the risk a customer is willing and able to take

3.14 Inappropriately simplified approaches have led to problems in some cases. For example:

- although most firms consider a customer's attitude to risk (such as their risk preferences or appetite for loss), often they do not consider other factors such as the customer's capacity for loss; and
- the adviser or discretionary manager assumed a customer is willing to take the risk of capital loss, without discussing with the customer whether the assumption is correct. This is exacerbated if the firm does not have a category to recognise customers that are best suited to placing their money in cash deposits.

3.15 Firms should be aware that customers may have different needs and be willing or able to take a different level of risk to meet these needs. For example, some customers may be willing to take a lower risk with their short-term savings needs and a higher risk with their longer-term pension arrangements.

Good practice

A firm used one process to assess the customer's attitude to risk and a separate process to assess the customer's capacity for loss ensuring both were appropriately considered as part of the suitability assessment.

Poor practice

A firm adopted a methodology in which the customer simply picked a number on a scale (of 1-10) where one end of the scale was described as low risk and the other described as high risk. This was a problem because the risk represented by each number was subjective. There was no certainty, in the absence of any other information, that the customer and the firm had the same interpretation of the level of risk a particular number represents.

Poor practice

A firm's methodology (which included the use of a risk-profiling tool) failed to filter out customers who were unwilling to risk capital loss.

Using poor questions in risk assessment questionnaires

3.16 Firms often use questionnaires to obtain information from their customers. Questions that are not clearly worded, or where the content is unlikely to be understood, can result in customers not giving answers that accurately reflect the risk they are willing and able to take.

3.17 The possibility of customers misunderstanding the questions they are being asked could be exacerbated if the questions:

- are vague, use double negatives or complex language that the customer may not understand;
- are not suitable for use with the firm's customer base, for example because they assume the customer has particular knowledge or experience such as a good level of financial knowledge or mathematical ability, and that the customer is comfortable in applying it; or
- are structured in a way that could invite different answers - for example, because they ask two questions in one and the customer might want to record a different answer to each sub-question.

Poor practice

Questions used to assess the risk a customer is willing and able to take:

1. With the money you have to invest, would you select:

(a) a product where there is very low risk of losing your money and the return is 5% pa on average; or

(b) a product where you could lose up to 15% in a year and the return is 10% pa on average; or

(c) to split your money between the two products?

(This question is complex, assumes a high level of mathematical and financial ability, and assumes that all customers will be able to identify an accurate reflection of their preferences in the three options provided.)

2. Placing some of my money in risky investments is something I like doing.

(a) Yes

(b) Sometimes

(c) No

(This question assumes investment experience and fails to quantify the amount of risk or money involved.)

3. When do you need to get back the money you invest, or start receiving an income from it?

(a) 1-4 years

(b) 5-10 years

(c) Over 10 years

(This question asks two questions in one – the customer might need income from the investment immediately and capital return at a later date.)

Inappropriately interpreting customer information

3.18 The number of questions firms ask their customers can vary significantly. The fewer the questions – coupled with a possibility of misinterpreting an answer – the greater the probability is of making an inaccurate assessment. We have seen cases where the resulting risk category is effectively determined by the answer to one question. For example, a customer answers a set of questions in a particular way and is assessed as willing to take a given level of risk. Another customer gives precisely the same answers for all but one of the questions (and it can be any question that is answered differently). The single different answer can result in the customer being allocated a higher-risk category and assessed as willing to take a greater level of risk. Where such sensitivity is built into a firm's approach, the firm needs to be aware of the reliance being placed on each answer and the risks associated with doing so. The firm needs to take particular care to ensure a customer understands each question and that the answers they give are an accurate reflection of their views.

3.19 We are also concerned that some questionnaires invite a customer to select the option with which they most agree with. Options that are vague could be interpreted by customers and firms in different ways leading to poor outcomes. For example, where questionnaires use non-committal 'middle' answers customers could interpret these as having a neutral effect (effectively a non-answer): these could be selected by customers to reflect a lack of understanding, a lack of investment experience or may simply indicate that they do not agree with any of the answer options. If the firm interprets such answers as a true 'middle' answer, scoring it as reflecting a mid-range attitude to risk without further discussion with the customer, a flawed risk profile can result.

Poor practice

A firm used a set of questions where a number of the questions asked had the option to answer 'neither yes or no'. Because a middle weighting was attributed to these answers, a customer that chose this answer for all or some of these questions, could be assessed as having a risk profile in the middle of the scale of risk categories. This could have resulted in an inaccurate assessment of the risk the customer is willing to take where the customer's answer reflected a 'non-answer' rather than a willingness to take the level of risk attributed.

Good practice

Recognising that their risk-profiling tool had limitations, a tool provider built steps into the process for advisers and discretionary managers to validate outputs and resolve potential conflicts in answers to different questions. The tool validated each concept tested with a number of questions and answers and highlighted conflicting answers prompting the adviser to have an informed discussion with the customer to clarify the risk they were willing to take.

3.20 Part of the skill of an adviser or discretionary manager is considering and evaluating different pieces of information to form a recommendation for the customer. It involves weighing up the advantages and disadvantages of alternative solutions by making trade-off decisions that best meet a customer's investment objectives and reflect their financial situation.

3.21 We have seen instances where information such as the customer's attitude to risk and their capacity for loss is gathered together along with information related to the term of the investment or the age of the customer and conflated into a single output.

3.22 By bundling information on different factors together, the value of each distinct piece of information is potentially lost because arbitrary weightings are applied to different factors which may negate a preference or need. This can result in output that does not accurately reflect the trade-off decisions that a customer is willing or able to take. If such an approach is used, the tool, or wider suitability assessment process, needs to be capable of accounting adequately for each of the different pieces of information.

3.23 In other words, a firm needs to be able to demonstrate how any recommendation or transaction is suitable for a particular customer given each of the constituent parts of the suitability assessment (paragraphs 3.2-3.3).

3.24 We have seen approaches to assessing the risk that the customer is willing and able to take (including where tools are used) that concentrate separately on the customer's attitude to risk or capacity for loss and therefore avoid this conflation risk.

Poor practice

We saw tools that conflated pieces of information relating to the wider suitability assessment and the risk a customer is willing and able to take into a single automated output. The effect of automatically weighting the different pieces of information to produce a single output was such that one answer could drive the output to the extent that customers were excluded from being rated in risk categories that may have been suitable for them, for example because they were under a certain age or investing for a certain period.

Updating the assessment

3.25 A firm can rely on information already provided by customers unless it is aware that the information is manifestly out-of-date, inaccurate or incomplete.[13]

3.26 Firms should have clear processes to ensure they consider whether they need to review and, if necessary, update a customer's risk assessment when further investment advice is provided, or periodically for a discretionary or portfolio management service.

Good practice

A provider's tool automatically maintained a record of the risk profiles recorded for each customer along with the date that each assessment was made. This prompted the firm to consider whether a review was needed.

Checking the risk a customer is willing and able to take

3.27 Engaging with the customer to check that the risk a customer is willing and able to take was correctly assessed is a reasonable step firms can take to ensure that the outcome is suitable as long as:

- the descriptions and illustrations used in the process are drafted and presented in a way that explains the investment risk in a way that is fair, clear and not misleading; and
- the explanations clearly differentiate the level of risk between categories.

[13] COBS 9.2.5R

Such descriptions can also be a helpful way to reflect the level of risk inherent in any subsequent investment selection (discussed in Chapter 4).

3.28 We have found examples of descriptions that were not fit for purpose: they were unclear or misleading and did not effectively explain or differentiate levels of risk. This can result in a lack of engagement and a lack of customer understanding about whether the level of investment risk being attributed to them accurately reflects the actual risk they are willing and able to take.

Customer risk category descriptions are unclear or misleading

3.29 Descriptions of risk can be difficult for a customer to understand if, in particular:

- Descriptions or illustrations do not clearly quantify the level of risk. For example, using words such as ‘some’ to explain how much is typically invested in a particular type of asset or product type can be interpreted differently by firms and customers.
- The description of the investment strategy (including reference to the typical assets used within a category) is inconsistent with most customers' understanding of the risk posed by the category description. For example, one firm’s customer research indicated that their customers thought the risks posed by certain investments (specifically, exposure to UK and overseas shares) were higher than they would have anticipated from a category using the phrase ‘cautious’.
- Statements within descriptions are not balanced or use language that is misleading, judgemental, emotive or not objective (for example, using text such as ‘you are a sensible investor’). Language such as this can inappropriately influence rather than validate the level of investment risk the customer is willing to take.
- A number or name of a category is provided to the customer with no explanations of what it is intended to reflect.
- Descriptions or illustrations contain technical jargon that the customer may not understand, or are not fairly balanced or reflective of the risk-reward trade-off.

Poor practice

In the following cases, the descriptions of risk categories use ill-defined words and phrases that are open to interpretation. This increases the possibility that customers will interpret the level of risk differently to the adviser or discretionary manager. This is particularly a problem if customers read concepts (like 'some', 'reasonable' or 'moderate') as implying only a limited amount of the investment being placed at this level of risk but are in fact exposed to a higher amount of risk than they expected.

1. Several of a firm's risk categories that contained investments with different levels of risk were each described as suitable for a customer that was willing to take 'reasonable risk'. This failed to clearly explain, or differentiate, the different levels of risk across different categories.

2. A firm had categories that contained vague and understated language such as 'reasonable', 'steady', and 'moderate variation' to describe the level of risk and potential for loss. The descriptions did not adequately reflect the inherent risks involved in the asset-allocation recommended for the risk category which allowed the vast majority of the investment to be placed in investments where the value could be expected to vary significantly.

3. Other firms had categories containing language with emotive or judgemental connotations such as 'progressive', 'risk aware', 'realistic' and 'motivated'. We are concerned that the use of language like this, whether within the name of the categories or within the category descriptions themselves, is misleading, and might encourage customers to adopt them because they consider the connotations of the words used rather than the actual risk being described.

Good practice

A firm had risk categories with relatively broad definitions supported by brief sub-sections within each definition that in combination aided understanding. This included:

(d) a short summary description that was fair and balanced;

(e) bullet points that provided more detail of the risk of capital loss and the nature of typical investments in each category; and

(f) a simple chart showing the 'shape' and variability of annual returns over a period that helped the customer to understand that they needed to be comfortable to accept the gains and losses associated with a particular level of risk.

(This example was considered good because it attempted to explain the risk in a number of different ways. It included text and a visual representation, different elements of which might engage different customers. The chart included hypothetical returns illustrative of the level of risk described – it was not based on a particular investment selection and so was not based on projections or past performance.)

Inappropriate or missing risk categories

3.30 The way in which some firms structure their risk categories can make it difficult for customers to understand the investment risk to which they are committing. Structures that we have concerns with include:

- Extremely wide categories that capture customers across a broad spectrum of views. Firms should be aware of this issue and guard against investment selections that technically fit within the risk category but do not meet the specific needs of the customer. For example, where the risk a customer is willing and able to take is at the low end of a wide category but the investment selection is reflective of the high end of the category this is likely to lead to unsuitability.
- A gap between the risk profiles of different categories. For example, where there is a significant difference in the proportion that can be invested in equities for consecutive risk categories, this may create large jumps in the risk taken.

Poor practice

A firm had a large number of categories but had a large gap between the risk levels in two adjacent risk categories. One risk level allowed no equity investments but the adjacent risk level allowed for over half to be invested in equities.

The firm had no means to account for customers for whom it might be suitable to hold an intermediate amount in equities.

Lack of customer engagement and understanding

3.31 It is important that advisers and discretionary managers consider the knowledge and experience of customers and properly discuss with customers the nature of the assessment of the risk they are willing and able to take. This enables firms to secure customer engagement and check understanding. Where a firm does not adequately communicate and check understanding of the level of risk a customer is agreeing to take this can lead to unsuitable consumer outcomes - for example, where the customer commits to an investment selection on the basis of a misunderstanding of the level of risk involved.

Good practice

A firm used a risk-profiling tool which promoted a two stage approach to risk-profiling. The process involved the adviser or discretionary manager discussing the tool's provisional rating with the customer and recording with reasons whether or not this accurately reflected the risk the customer was willing and able to take.

Good practice

A firm provided a clear and balanced guide to investment risk for the customer to read in advance of assessing their risk profile. This included a summary of the process for assessing the risk a customer was willing to take.

4 Investment selection

4.1 This Chapter is relevant to advisers and private client discretionary managers. It focuses on how firms select investments for a customer once they have established the risk a customer is willing and able to take as part of a wider suitability assessment and 'know your customer' process.

Key risks for firms to consider

Poor outcomes can occur if firms, in particular:

- do not take appropriate account of all aspects of a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience;
- fail to challenge cases where automatically generated investment selections (for example, from model portfolios or asset-allocation tools) are unsuitable for individual customers;
- fail to ensure recommendations or transactions are consistent with the risk description confirmed with the customer;
- rely solely on volatility as a proxy for risk;
- do not recognise the importance of considering diversification; or
- fail to understand the nature and risks of products or assets selected for customers.

Our requirements

4.2 As we set out in the previous Chapter, a firm must act in the customer's best interests and take reasonable steps to ensure that any investment selection (including the underlying asset-allocation) is suitable. Suitability depends on a number of factors, including the risk the customer is willing and able to take. An investment selection that fails to take account of all relevant factors may be unsuitable.

Our findings

Robust investment selection process

4.3 We do not prescribe a methodology that firms must adopt in making investment selections. However, we are concerned that we have identified examples where firms are making unsuitable investment selections because they do not have a robust process that ensures that all relevant suitability factors are properly taken into account.

4.4 If none of the investment selections that are available to the firm are suitable for the customer, no recommendation or transaction should be made.

Poor practice

A firm relied solely on the use of a tool that assessed a customer's attitude to risk. There was very little information gathered to assess suitability other than that needed by the tool. It was clear that the results from the tool were the primary influence in making an investment selection and that there was a lack of appropriate consideration of other customer needs and circumstances.

Poor practice

When advisers at a firm recommended pensions, the firm's process obliged them to recommend its discretionary management service in every instance. This meant that the advisers did not consider adequately the suitability of the recommendation for individual customers or recognise that this investment approach was unlikely to be appropriate for all customers, such as those with a very small pension fund due to the additional costs incurred.

4.5 The rest of this Chapter highlights specific reasons why investment selections (including the underlying asset-allocation) can fail to reflect the risk the customer is willing or able to take.

Using automated investment selection tools and model portfolios

4.6 We have noticed an increased reliance on asset-allocation tools and model portfolios. It is our view that tools, and other structured approaches to selecting products and funds can be a useful starting point for an investment selection, when used as part of a robust suitability process.

4.7 However, if firms adopt such tools or structured approaches they need to have robust systems and controls to ensure that any advice or discretionary transaction made using the tool or approach is suitable for customers. This could include considering whether an automatically generated selection is suitable for the individual customer (including the risk a customer is willing and able to take).

Good practice

A discretionary management firm had a number of standardised initial asset-allocations. Portfolio managers had flexibility to tailor the solutions to individual customer circumstances. If they wished to make more changes than the limits allowed, the investment selection needed further sign-off. This prompted each portfolio manager to consider whether each investment selection was in the best interests of the customer.

Ensuring the investment selection is consistent with the customer's risk category description

4.8 We have seen examples where the investment selection was not consistent with the risk category descriptions provided to the customer, with no explanation for the difference. While we do not necessarily expect descriptions to outline specific asset-allocations, it is important that an investment selection matches the customer's risk expectations. Failure to do so is likely to lead to unsuitability.

Poor practice

In one firm the customer was assessed in a risk category described as having 'a reasonable proportion in with-profits and managed funds and a very small part in higher risk funds'. The advice to invest more than half of the investment in emerging market funds was inconsistent with this description.

Poor practice

One firm's customer risk description noted that there would be 'very little [invested] in managed funds'. The advice to hold 100% of the investment in a balanced managed fund was inconsistent with the description.

4.9 We have also seen an example of a firm inappropriately overriding the risk it had established a customer was willing and able to take because the customer's needs could not be met by the selection associated with the confirmed risk description.

4.10 In circumstances where a customer's needs conflict with the level of risk a firm has established the customer is willing and able to take, we expect the firm to have a detailed discussion with the customer. The firm should draw the customer's attention to any mis-matches in their investment objectives, financial circumstances, risk tolerance and capacity for loss. It should also explain the implications for the customer of making alternative trade-off decisions – for example, saving more, spending less, retiring later or taking more risk.

4.11 Where the customer does not have capacity to sustain the potential loss of a higher-risk strategy, the firm should explain that the customer's need for a higher return cannot realistically be met.

4.12 If the customer is able to sustain greater capital losses and is willing, following discussion, to tolerate a higher level of risk to potentially generate the desired level of return, the firm should document that this is the risk that the customer is willing and able to take, along with the reasons for this.

4.13 A firm needs to take care to establish the suitability of any investment selection that requires a customer to take on a higher level of risk than originally identified.

Relying solely on volatility as a proxy for risk and ignoring the risks of failing to consider diversification

4.14 We found examples of model portfolios and asset-allocation tools using volatility as the sole measure of risk. Firms using these tools need to take into account other measures of risk where these measures are relevant to the customer, such as the underlying assets in a fund, or risks related to the structure of the product. For example, inflation risk, liquidity risk, the risk arising from a lack of diversification or specific risks associated with the features of some types of product including its structure, such as counterparty risk. In addition, some assets are not traded daily on mainstream markets and can be difficult to value or appear to have low volatility, but are not low risk.

4.15 We are concerned that, where firms solely use volatility as a proxy for risk and ignore other risks, this can result in investment selections that, for example, include complex assets that may not be suitable given the risk the customer is willing and able to take.

4.16 We also found examples of firms insufficiently considering the benefits of the diversification of products or asset classes, including across fund managers and counterparties, or insufficient recognition that a lack of diversification can increase risk. This issue has been highlighted in recent mis-selling cases - for example Lehman-backed structured investment products where firms sold investments in high concentrations because they misunderstood the associated and underlying risks.[14]

Poor practice

A firm recommended that a customer invest 100% of their personal pension in one property fund. Regardless of whether or not it was appropriate for the firm to consider the property fund to be low risk, in deciding that the investment selection was suitable for the customer's preference for a low risk, less-volatile investment, the firm failed to consider other risks relevant to the customer's needs and circumstances, including liquidity risk and the risk of relying on the performance of a single asset class in a single market.

Poor practice

A firm had a limited product range for advisers to use, particularly for lower-risk customers. This resulted in recommendations for a single product, with a single underlying asset type, where customers said that they did not want to take the risk inherent in other available products. The recommendations sometimes resulted in an unsuitably high concentration of the customer's investment in one high risk asset class.

[14] http://www.fsa.gov.uk/pubs/other/qa_structured.pdf

Understanding the underlying risks in an investment selection

4.17 We are concerned that our findings suggest some firms are not taking adequate care to ensure they have a sufficient understanding of the features and risks of their investment selections. If an adviser or discretionary manager does not have a satisfactory understanding of the products they recommend or transact within a discretionary portfolio, there is a clear possibility of poor outcomes for their customers.

4.18 For example, we expect advisers and discretionary managers:

- Not to assume that a fund whose name appears to match a customer risk category is suitable without taking reasonable steps to ascertain that it is compatible and relevant for the level of risk a customer is willing and able to take. The underlying asset selection should be suitable for the particular customer. In other words, a fund labelled as 'balanced' may not be suitable for a customer assessed as having a 'balanced' attitude to risk; it would depend on, amongst other things, the content of the fund, the fund's investment strategy and the nature of the risk category description. The adviser or discretionary manager may also have a meaningfully different concept of a 'balanced' attitude to risk to the one used by the fund manager.
- To understand distinctions in risks between different types of products especially those deemed to be 'low risk', for example the differences between money market 'cash' funds and bank or building society savings deposit accounts.
- To understand the risks of complex products they select as well as the nature of the underlying risks of assets and markets in which they invest. This is because product structures, as well as the underlying investments, can contribute to the risk involved.

4.19 It is important that firms consider what due diligence and research they need to undertake to ensure they are familiar with the nature and risks of the products and funds they select for customers.

Good practice

A medium-sized discretionary management firm identified internal experts in specific subject areas. The clear designation of responsibility meant that individuals took responsibility for ensuring they carried out robust research and due diligence for their subject area before feeding their analysis into the firm's wider research work. Regular rotation of expert areas helped to maintain wider individual competency and supported robust internal challenge.

Good practice

Before advising on a product, a small advisory firm sourced independent reviews of the product and reviewed other similar products to understand for itself how a product compared with others available.

Poor practice

A firm over-relied on provider information when researching the suitability of a product for its client base. There were gaps in the provider's information and as a result the firm failed to understand the nature of the risks of the product (which contained non-traditional assets). This led the firm to inappropriately rate the product as lower risk.

5 Adopting third-party tools

5.1 Many firms use tools designed and created 'in-house', or 'off-the-shelf' tools provided by third parties when making a suitability assessment for a customer. It is important to highlight that the firms providing the advice or discretionary management remain responsible for assessing suitability, even if they use a tool provided by a third party as part of assessing the risk a customer is willing and able to take.

5.2 This Chapter focuses on our view of the responsibilities of those firms that adopt third party tools and how tool providers can assist firms to meet these.

Key risks for firms to consider

Poor outcomes can occur if firms, in particular:

- use tools which are not fit for purpose;
- do not understand how a tool works or its limitations; or
- fail to mitigate a tool's limitations within the suitability assessment.

Our expectations

5.3 While we view risk-profiling and asset-allocation tools as potentially useful in aiding advisers and discretionary managers, they often have limitations and may not be able to, on their own, determine the risk a customer is willing and able to take, or to make a suitable investment selection, in all circumstances.

5.4 If a firm uses a third-party tool to help make suitability assessments for their customers, we expect that firm to:

- ensure that the tool is suitable for use with its customer base;
- understand how the tool works, so it can interpret and evaluate the results when it is applied to individual customers;
- understand to what extent the tool will help meet its regulatory requirements;
- have a robust process to mitigate shortcomings or limitations of the tool; and
- where a tool (such as an asset-allocation or fund-selection tool) suggests investment selections, to understand the product, market and asset risks for these investments.

5.5 Providers of tools can assist the firms who use their tools by:

- ensuring the tools perform as intended and as described to the firms that use them.
- providing supporting information to firms that will use the tools, so that they can understand:
    - the extent to which the tool will help the firm meet their regulatory requirements;

  - the scope of the tool including situations for which it has, or has not, been designed to work;
  - any limitations of the tool, including any circumstances for which the tool should not be used;
  - any assumptions relevant to the use of the tool, for example, about the advice or discretionary management process or target market; and
- ensuring that supporting information is clear and easily accessible.

Our findings

5.6 Our findings suggest that some firms rely on the output from third-party tools without fully understanding the limitations or the circumstances under which the tool should or should not be used. Firms should be particularly mindful of the risks of an approach using different elements of different tools in a single suitability assessment as this could lead to tools being used differently to the way intended. For example, the definition of 'cautious' generated by a risk-profiling tool could be different to the risk of a 'cautious' portfolio generated by an asset-allocation tool if they are using different underlying assumptions.

5.7 Firms need to take reasonable steps to ensure that the tool is fit for purpose, taking into account their business model and suitability assessment process.

5.8 Aspects of tools, such as the underlying assumptions and the scoring mechanisms, can require detailed information to fully understand. Advisers and discretionary managers have a responsibility to demand all relevant information from the tool provider to enable them to determine whether a tool is appropriate for use with their customer base. Third-party tool providers have an important role to play in providing this information.

Good practice

A risk-profiling tool provider produced a guide for firms to assist them in understanding factors to consider when using its risk-profiling tool. It included tips and guidance in areas such as: when to use the risk profiler and events in a customer's life that may indicate a need to re-evaluate their risk profile. The guide also stated that an adviser or discretionary manager should not rely solely on the outputs of the risk profiler but should validate it with further customer discussion. The guide prompted further discussion of the risk a customer was willing and able to take in light of their specific needs and circumstances.

Poor practice

A firm used a third-party risk-profiling and asset-allocation tool with a large number of risk categories. To aid customer understanding the firm added its own descriptions to each of the numbered categories. However, as the firm did not fully understand the nature of the underlying tool categorisation the name and description attributed to the categories did not correctly reflect the risks the customer was exposed to.

6 Summary of changes to final guidance as a result of consultation

Section	Consultation Guidance	Final Guidance
1.6	We do not prescribe **how** firms establish the risk a customer is willing and able to take or how they make investment selections.	We do not prescribe **how** firms establish the risk a customer is willing and able to take, or how they make investment selections, accepting that firms should give due consideration to the nature and extent of the service provided.
1.8	We have identified common approaches that can lead to an inadequate assessment of the risk a customer is willing and able to accept:	We have identified common approaches that can lead to an inadequate assessment of the risk a customer is willing and able to ~~accept~~ take:
Page 6 summary table	**Firms should ensure:** • they have a robust and flexible process for ensuring investment selections are suitable given all aspects of a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience;	**Firms should ensure that, in particular:** • they have a robust and flexible process for ensuring investment selections are suitable given ~~all aspects of~~ a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience;
Page 9 summary table	**Key risks for firms to consider** Poor outcomes can occur if firms: • …….	**Key risks for firms to consider** Poor outcomes can occur if firms, in particular: • …….
3.3	As part of this, firms must obtain from the customer such information as is necessary to understand the essential facts about them and have a reasonable basis for believing that a recommendation or transaction entered into: • ……..	As part of this, firms must obtain from the customer such information as is necessary to understand the essential facts about them and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended ~~a recommendation~~ or ~~transaction~~ entered into in the course of managing: • ……..

3.17	The possibility of customers misunderstanding the questions they are being asked could be exacerbated if the questions: • are vague, use double negatives or complex language that the customer may not understand; • assume the customer has particular knowledge or experience such as a good level of financial knowledge or mathematical ability, and that the customer is comfortable in applying it; or • …….	The possibility of customers misunderstanding the questions they are being asked could be exacerbated if the questions: • are vague, use double negatives or complex language that the customer may not understand; • <u>are not suitable for use with the firm's customer base, for example because they</u> assume the customer has particular knowledge or experience such as a good level of financial knowledge or mathematical ability, and that the customer is comfortable in applying it; or • ……
3.26	Firms should have clear processes to ensure they review and, if necessary, update a customer's risk assessment when further investment advice is provided, or periodically for a discretionary or portfolio management service.	Firms should have clear processes to ensure they <u>consider whether they need to</u> review and, if necessary, update a customer's risk assessment when further investment advice is provided, or periodically for a discretionary or portfolio management service.
3.29	Descriptions of risk can be difficult for a customer to understand if: • ……. **Good practice** A firm had risk categories with relatively broad definitions supported by brief sub-sections within each definition that in combination aided understanding. This included: (g) a short summary description that was fair and balanced; (h) bullet points that provided more detail of the risk of capital loss and the nature of typical investments in each category; and a simple chart showing the 'shape' and variability of annual returns over a period that helped the customer to understand that they needed to be comfortable to accept the gains and losses associated with a particular level of risk.	Descriptions of risk can be difficult for a customer to understand if<u>, in particular</u>: • ……. **Good practice** A firm had risk categories with relatively broad definitions supported by brief sub-sections within each definition that in combination aided understanding. This included: (i) a short summary description that was fair and balanced; (j) bullet points that provided more detail of the risk of capital loss and the nature of typical investments in each category; and a simple chart showing the 'shape' and variability of annual returns over a period that helped the customer to understand that they needed to be comfortable to accept the gains and losses associated with a particular level of risk.

		(This example was considered good because it attempted to explain the risk in a number of different ways. It included text and a visual representation, different elements of which might engage different customers. The chart included hypothetical returns illustrative of the level of risk described – it was not based on a particular investment selection and so was not based on projections or past performance).
3.31	**Good practice** A firm formally sought confirmation that the customer understood and agreed to the level of risk described.	[Deleted]
Page 20 summary table	**Key risks for firms to consider** Poor outcomes can occur if firms: • …….	**Key risks for firms to consider** Poor outcomes can occur if firms, in particular: • …….
Heading at 4.14	Relying on volatility as a proxy for risk and ignoring the risks of failing to consider diversification	Relying solely on volatility as a proxy for risk and ignoring the risks of failing to consider diversification
4.15	We are concerned that, where firms use volatility as a proxy for risk and ignore other risks, this can result in investment selections that, for example, include complex assets that are not suitable given the risk the customer is willing and able to take.	We are concerned that, where firms solely use volatility as a proxy for risk and ignore other risks, this can result in investment selections that, for example, include complex assets that ~~are~~ may not be suitable given the risk the customer is willing and able to take.
Page 26 summary table	**Key risks for firms to consider** Poor outcomes can occur if firms: • …….	**Key risks for firms to consider** Poor outcomes can occur if firms, in particular: • …….