



# BEYOND BOX-TICKING: LEVERAGING ENHANCED RISK-PROFILING TO IMPROVE CLIENT EXPERIENCE

## >> FOREWORD <<

# Enhanced Risk-Profiling: Tackling Relationship Risk Head On

The world of wealth management remains in flux, with regulatory and margin pressures, not to mention shifting client requirements, forcing firms to take a long, hard look at how they run their businesses. Compliance concerns are front of mind as watchdogs the world over continue to flex their muscles and the global clampdown has meant that some wealth management firms are now spending up to half of their net profits on complying with the rising burden of regulation. This at a time when the average cost/income ratio of the world's wealth managers hovers at around 80 per cent.

Against this backdrop, client risk-profiling and suitability assessment have become even more important pieces of the compliance puzzle. Regulators continue to hand out weighty fines to wealth managers for related failings and firms are racing to upgrade their risk-profiling processes and systems in response.

However, when it comes to the risk-profiling revolution going on today, it would be inaccurate to paint a picture of the world's wealth managers scrabbling to keep up with regulatory demands with heavy hearts. There is in fact something wholly more positive going on as firms increasingly recognise that enhanced risk-profiling is about far more than just avoiding regulatory censure and the associated business risks – it's actually also about *relationship* risk.

The title of this report is intended to reflect the fact that client risk-profiling needs to be seen as far more than a box-ticking exercise, and while compliance is naturally a priority it is actually only the start of the story. What the world's leading institutions are doing is embedding high-quality risk-profiling at the heart of their offering to keep their relationships with clients, and their reputations, out of jeopardy.

As well as regulators ratcheting up their attentions on this side of firms' activities, the respondents to the reader survey confirmed that clients themselves are now bringing up the "risk question" more than ever before. In the context of the recent financial crisis and ongoing market uncertainty, heightened concerns from clients are of course understandable, but what is really interesting is how some firms are turning this challenge into an opportunity to differentiate themselves from their peers.

The results of the reader survey on which this report is based are interesting on several fronts, not least as an indication of the widespread changes which firms have made, and continue to make, to their risk-profiling processes. The most intriguing findings however concern the benefits which enhanced risk-profiling can confer on both institutions and the clients they serve.

While they come from a wide range of backgrounds, the panel of industry experts who contributed to this report were united on one key point: rather than wringing their hands in the face of the risk-profiling challenge wealth managers should grab the initiative and place accurate, in-depth and dynamic risk-profiling at the heart of their propositions – for the benefit of all.

As the expert insights contained within this report will elucidate, those firms which invest both the time and resources into making their risk-profiling processes truly "best in class" will capture a huge range of operational efficiencies, along with a whole range of other benefits. These benefits are wide-reaching and naturally include the protection of the brand; nothing is more damaging to the image of a firm than to be seen as a "product pusher" which pays little heed to the true investment needs of its clients. However, it is arguable that improving client experience is where enhanced risk-profiling processes can make the biggest difference.

Investment management is of course a "numbers game" but we should never overlook the emotional side of things and, as will be discussed, it is essential that clients feel comfortable with their portfolios and the levels of risk they have taken on. But at its best enhanced risk-profiling can have an even greater impact, encouraging a more open and honest client-advisor relationship and ultimately empowering clients to better understand their own investment behaviour.

So, while at first glance risk-profiling might seem to be predominantly a compliance or technology-related issue, its significance actually runs far deeper than that. In fact, as the findings of this report suggest, it actually cuts to the heart of the wealth management proposition and is key to delivering a truly customised, client-centric service. In short, enhancing risk-profiling is inextricably linked to enhancing the client experience.



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Empowering Clients Through Enhanced Risk-Profiling

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### **RICHARD ANDERSON**

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Based in London, Richard Anderson is head of wealth planning and Retail Distribution Review at Lloyds TSB Private Banking, a role in which he is responsible for the advice strategy and proposition to meet UK wealth client needs. Anderson is also charged with developing and delivering the RDR project for private banking; he has spent nearly 30 years with Lloyds Banking Group – the majority of which in Scottish Widows in a variety of senior operational sales and strategic roles predominantly within the IFA marketplace. He has also held a number of senior external roles, including serving as vice president of the Chartered Insurance Institute for six years.



### **GRAHAM BENTLEY**

**Head of Proposition, Skandia**

Graham Bentley is responsible for the proposition for all offerings within the Skandia UK business, including both Skandia Life and the Skandia Investment Solutions platform. Bentley has over 30 years' experience in investment business, including most recently six years as head of investment marketing at Selestia. An expert in behavioural finance and the psychology of investing, Bentley is a frequent speaker on investment matters and a contributor of features and articles in the investment trade press.



### **GREG DAVIES**

**Managing Director and Head of Behavioural and Quantitative Investment Philosophy, Barclays**

Greg Davies leads a global team of behavioural and quantitative finance specialists who are responsible for the design and global implementation of the Barclays investment philosophy. Davies, who has a commercial background in strategy consultancy, is an Associate Fellow in Executive Education at Oxford University's Saïd Business School and his first book, *Behavioural Investment Strategy*, was recently published by McGraw-Hill. The author of papers in multiple academic disciplines, he presents regularly at conferences, and is a frequent media commentator on behavioural finance. Davies holds an MPhil in Economics and a PhD in Behavioural Decision Theory, both from Cambridge University.



### **SEB DOVEY**

**Managing Partner, Scorpio Partnership**

As managing partner of Scorpio Partnership, Seb Dovey manages the development and execution of strategic recommendations, completing assignments for all manner of firms in the wealth management space. Dovey, who is also currently involved in creating and building education-based solutions for a number of clients, is a regular media commentator and has chaired and presented industry events in Asia, Europe and the US. Dovey has also lectured at The Swiss Finance Institute for its executive MBA programme. He serves on the editorial board of *WealthBriefing* and is chairman of the advisory board of B-Hive, a network for global private client investors. Dovey holds a first class BA (Hons) degree in Modern History from University College London and an MSc (Econ) with distinction from the London School of Economics.



### **TRACY MAETER**

**Head of Investments, British Isles, RBC Wealth Management**

Based in London, Tracy Maeter has overall responsibility for RBC Wealth Management's discretionary and advisory investments platforms in the British Isles. Earning her Bachelor of Finance and Economics at Massachusetts Institute of Technology, she completed her graduate degree at Columbia Business School. Maeter joined RBC Wealth Management in the summer of 2010 from HSBC, where she was head of investors, based in London. Prior to her role in investments, she built and managed the HNW team and launched the sales management division. Prior to her time at HSBC, Maeter held several positions at JP Morgan, beginning with the capital markets desk in derivatives and subsequently debt capital markets. From here, she moved on to become a relationship manager in the private bank for UHNW clients.



**BENJAMIN MANZ**  
Managing Partner, Assetinum

Benjamin Manz is the founder and managing partner of Assetinum, a Swiss consulting firm and independent information portal for investors. Manz studied Philosophy and Cultural Studies at the University of Zurich and in Berlin before founding his own copywriting firm while he was still studying. After that he worked for various companies in the fields of strategy and development before launching Assetinum, together with two other entrepreneurs, Samuel Manz and Kean Madjdpour.



**JOSS MITCHELL**  
Director and Head of UK Business Development, Citi Private Bank

Joss Mitchell joined Citi Private Bank in September 2010 from HSBC Private Bank, where he was a director and regional head of the private banking business in Scotland. Prior to this role, Mitchell had fulfilled since 2002 a number of roles within HSBC's institutional and private client investment management business. Having started his career in 1987 with Mercury Asset Management, where he was part of the institutional fixed income team, Mitchell moved to Credit Suisse Private Bank in 1994 as a global equity fund manager managing assets on behalf of international private clients. Following this he joined Deutsche Private Bank in 1998 as a discretionary portfolio manager focusing on US equities for private clients.



**MARTIN O'HARE**  
Head of Investment Solutions, Signia Wealth

Martin O'Hare joined Signia Wealth as managing director, head of investment solutions in December 2011. Prior to this he was chief investment officer at Société Générale Private Banking Hambros, where he worked for over seven years. In this role O'Hare chaired the investment committee meetings and he was also responsible for the management of the investment business. Previously, O'Hare worked at Merrill Lynch Investment Managers, where he was a senior portfolio manager focusing on global equity markets and he managed portfolios for both international and UK clients. O'Hare has an MA in Economics from the University of Glasgow and a Master of Science in Business Information Technology from Strathclyde Business School.



**CASPAR ROCK**  
Chief Investment Officer, Architas

Caspar Rock is responsible for directing the Architas' investment activity and overseeing the structure, responsibilities and control of the investment function. Rock's role also includes the recommendation of appropriate investment strategies to other areas of the AXA business. In addition to leading the Architas investment team, Rock, alongside Sheldon Macdonald and Dawn Kendall, runs Architas' six actively-managed funds of funds.



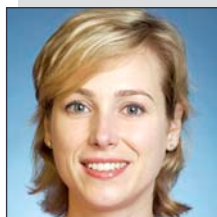
**MARTIN ENGDAL**  
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Martin Engdal has been with Advent for eight years and has worked in several senior sales and business development roles supporting the extensive business growth of Advent in the EMEA region. Engdal has responsibility for product marketing, business development and Advent EMEA's Alliance Partners within the wealth and asset management industry. Prior to joining Advent, Engdal worked as head of client relationships and portfolio manager at Danske Bank, Alfred Berg Asset Management and Nykredit Asset Management; he also served as director of pre-sales at SimCorp.



**DARYL ROXBURGH**  
Global Head, BITA Risk

Daryl Roxburgh's career spans more than 25 years in private client and institutional investment management firms. A graduate of what is now the Cass Business School, he began his career as a private client fund manager with Buckmaster & Moore, progressing to general manager, private clients, then to IT director for what had become Credit Suisse Asset Management. Roxburgh next moved to M&G as a senior consultant and before joining Prudential Portfolio Managers as global head of IT. After a period with City Consultants, Daryl joined BITA Risk in 2004, where he has led the design of its range of private client applications. Roxburgh was one of the founding directors of the London Quant Group, is a regular conference speaker and works with clients around the world on client risk assessment.



### SUZANNE SPINK

UK Head of Global Investment Solutions, Deutsche Bank Private Wealth Management

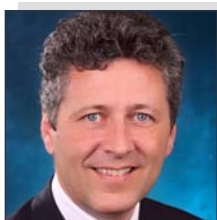
Suzanne Spink is the UK head of Global Investment Solutions at Deutsche Bank's Private Wealth Management unit. Spink's career in finance includes investment and private banking, with the majority of her experience within private banking. She began her career in 1995 with JP Morgan Private Bank in New York, responsible for the coverage of actively trading clients. In 1999 Spink was transferred to JP Morgan's Private Bank in London to create and manage a similar business focusing on European markets for the bank's global private clients. She moved to HSBC Private Bank in 2005 and built an investment advisory business covering all asset classes and products before going on to join Deutsche Bank Private Wealth Management in March 2011. Spink received a BA in International Business and Political Science from Marymount College.



### IAN STOTT

Client Services Director, The Consulting Consortium

Ian Stott has 20 years' experience working in financial services, specialising in sales and marketing. He is experienced in regulatory compliance matters across various sectors, including wealth management, discretionary and advisory asset management, product and service distribution through IFAs, networks and legal/accounting professionals. In addition to holding various financial services consulting roles, Stott has also spent 10 years in an overseas specialist engineering and manufacturing business, IST Metz, where he held various positions including global head of sales and marketing and managing director. Stott has also held roles with Target Life, Homeowners Friendly and Tax Invest group.



### GARY TIERNAN

Global Head of Investment Advisory, Standard Chartered Private Bank

Gary Tiernan, who joined Standard Chartered Bank in 2008, is responsible for various teams globally, and is a member of the private bank's global management committee and the global investment council. He is also a board member of Standard Chartered Trust (Cayman) and Standard Chartered Trust (Guernsey). Tiernan's career spans 25 years, both in investment and private banking. He has been in private banking since 2000, and before joining SCB was Asia head of investments and sales for Deutsche Bank Private Wealth Management. Before moving to Asia in 2004, Tiernan was head of product management and investment solutions for Deutsche Bank Private Wealth Management in Switzerland. Tiernan has a BA in Economics, Accounting and Financial Management from Sheffield University. He has also attended the Program for Executive Development at IMD Business School in Switzerland.



### BRUCE WEATHERILL

Chief Executive, Weatherill Consulting

Together with his colleagues, Bruce Weatherill, chief executive of Weatherill Consulting, provides strategic advisory and consultancy services to the boards of wealth and investment management firms across the world. Operating as a sounding board for senior executives, Weatherill Consulting brings to bear over 30 years of international experience to help wealth managers, both onshore and offshore, meet the challenges they face. A unique methodology of measuring and realising the benefits of "Trusted Advisor Status" has been developed by Weatherill Consulting to assist wealth managers in improving their services to HNW clients, increase profitability, enhance their brand and provide value-added services to their clients.



### IAN WOODHOUSE

Director, PricewaterhouseCoopers EMEA Private Banking and Wealth Management Practice

Ian Woodhouse is a key member of PricewaterhouseCoopers' EMEA Private Banking and Wealth Management Practice and has 20 years of experience in providing consultancy support to private banks and asset managers. He has worked on assignments for several leading wealth managers and is currently working on Retail Distribution Review preparation, developing stronger advice propositions which better align client and product risk and in using technology to help advisors deliver greater client value. Woodhouse is a thought-leader within the industry and is a lead author of PwC's highly-respected *Global Private Banking and Wealth Management Survey*.

## &gt;&gt; SECTION 01 &lt;&lt;

# Clients Are Bringing Up The Issue Of Risk Themselves Now More Than Ever Before

*"Clients are now more cautious, educated and informed about the trade-off between performance, risk and volatility; even basic mutual funds are now being risk and volatility rated and so this topic is increasingly at the forefront of client's minds"*

– Ian Woodhouse, director, PwC EMEA Private Banking and Wealth Management

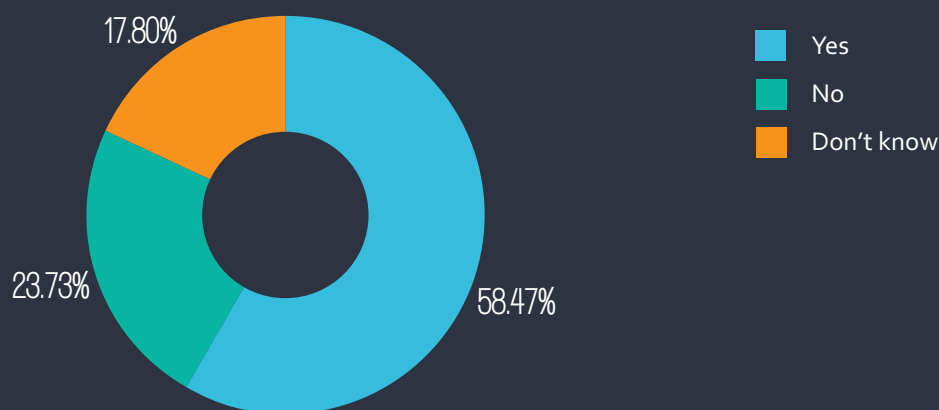
Clients have become more demanding than ever in the years following the financial crisis, and the trend seems to be towards them wanting to see their advisors more and to be more informed on all aspects of risk. In large part – in light of the painful losses associated with the crisis - they want to know they are protected on the downside and that further market wobbles won't completely stymie their life goals.

officer at Architas. "In light of the current economic climate and preceding five years, our clients are generally more aware of risk and some have shown a greater degree of interest in the risks associated with their investments," added Suzanne Spink, UK head of Global Investment Solutions at Deutsche Bank Private Wealth Management. This is of course a trend which rears its head periodically, as in the words of Gary Tiernan, global head of investment advisory at Standard Chartered Private Bank, "historically, periods of market stress and correction tend to lead clients to focus more on risk."

## Increased sophistication

Another outcome of the financial crisis is that people in general have

IN YOUR EXPERIENCE, ARE CLIENTS THEMSELVES BRINGING UP THE ISSUE OF RISK MORE NOW THAN BEFORE THE CRISIS?



That clients are now more concerned about risk was certainly borne out by the results of the reader survey: a majority 58 per cent of those surveyed said that they are seeing clients themselves bringing up the issue of risk than before the crisis (24 per cent responded in the negative, while 18 per cent said they didn't know).

The senior executives involved on this report also broadly reported the same trend occurring within their own firms' client bases – and this looks set to continue while markets are still somewhat uncertain and the world's largest economies have yet to properly put their houses in order. "The feedback we have had from clients is that there is a greater awareness of risk than before, but that is perhaps unsurprising given the volatility seen in the last four years and the falls in equity markets since the beginning of century," said Caspar Rock, chief investment

become a lot more financially literate – how many people would have known what a collateralised debt obligation signified before, for example? Along with the crisis, the "democratisation" of information on the whole spectrum of financial services via the internet and social media has arguably created a much more sophisticated client base.

As Ian Woodhouse, director, PwC EMEA Private Banking and Wealth Management, notes: "Clients are now more cautious, educated and informed about the trade-off between performance, risk and volatility, and even basic mutual fund are now being risk and volatility rated and so this topic is increasingly at the forefront of client's minds."

Other commentators however are somewhat more sceptical as to whether clients have become that much more sophisticated in their



understanding of risk in particular. A focus on risk (some might say fear) does not necessarily translate into a real understanding of its intricacies, they point out.

This is certainly the case for Daryl Roxburgh, global head of technology vendor BITA Risk, who notes that it's hardly surprising given the events of recent years that clients are much more aware of risk. "However, this has not necessarily increased their understanding of the various risks of investing, as these have broadened with the increases in liquidity and counterparty risk," he said.

As well the fact that clients still broadly lack a deep understanding of all aspects of investment risk, there is also the fact that the increased focus on risk is reactionary and therefore clients might still be taking too narrow a view.

For Greg Davies, head of behavioural finance at the wealth and investment management division of Barclays, the increased focus on risk is "largely a cyclical shift rather than a structural one" and clients may still be looking in the wrong direction.

"The turmoil investors have experienced over the last few years, and the media attention that comes with it, naturally draws attention to risks rather than the (sometimes irrational) focus on anticipated upside that occurs when markets are exuberant. Ironically, of course, clients would be better to have increased focus on risk when things have further to fall," he said.

There is clearly a need for firms to help educate clients about risk in all its guises and to prevent them getting caught up in the pendulum swings of caution and exuberance which accompany market cycles. For BITA Risk's Roxburgh, when it comes to risk most clients present a combination of "awareness and limited understanding" which makes it really important to give them clear illustrations of risk so that firms and clients can come to a common understanding.

There are several facets to the need for clients to understand risk better, but arguably the most pressing need is for them to understand more fully the risk profile of investment products. The UK Financial Services Authority's 2011 *Consumer Awareness Survey* found that those surveyed "in general do not now how to categorise financial products in terms of risk", although – as might be expected – there is greater knowledge among those who have bought the products in question. While 30 per cent of consumers across the board did not know the risk profile of investment with profit bonds, this fell to 15 per cent among those who had actually invested in them. Although the FSA's survey concerned the "generalist" consumer rather than HNW investors – who might be assumed to be more knowledgeable, if only by virtue of the fact that they will in all likelihood have invested in a greater variety of products – such a widespread lack of knowledge is still clearly worrying.

Another aspect of the education question is the difficulty of coming to a "common understanding" of risk/return trade-offs and for clients to take on board how much risk they must necessarily take. For Tracy Maeter, head of investments for the British Isles at RBC Wealth Management, this is actually one of the most important parts of the advisory process.

"Clients unsurprisingly focus on their return objectives. Classically, this often leads to a discrepancy between the returns that they are seeking and the risk that they're willing to take on," she said. "This is particularly relevant in today's environment where returns are less compelling and the risks are more evident. The recent crises have provided a useful catalyst for both the industry and clients to

understand the risks implicated in portfolios."

Deutsche Bank Private Wealth Management's Spink also sees the market swings of recent years as (ironically) having had a positive effect on some elements of the client-advisor relationship. According to Spink, the tough times (and the current uncertainty) have made tough conversations easier to have. "As a result [of recent difficulties], clients are often more receptive and open to robust conversations about their investment objectives and underlying motivation, together with the level of risk required to meet their planning needs," she said.

### Taking on necessary risk

While the fact that clients are now more aware of the realities of risk is to be welcomed, several firms have warned that some clients have become so risk-averse that they aren't taking the levels of risk necessary to achieve their planning goals, such as retirement at the time they desire.

The UK FSA's 2011 *Consumer Awareness Survey* found that, overall, 61 per cent of respondents "were not willing to take any risk with investments" (3 per cent higher than in 2010) and that just 4 per cent were prepared to take risks to gain higher returns (a fall of 2 per cent from the previous year). This widespread risk aversion is worrying to many within the industry, particularly to pensions specialists. In April 2012 Fidelity Investments published research which indicated that about 21 per cent of pension investors are too conservative with inadequate exposure to equities based on their current age and their desired retirement age.

Some striking figures illustrating UK investors' aversion to risk came from AXA's January 2012 *Wealth Self* study, which found that people are twice as likely to take a risk with their health than with their wealth or career. The research revealed that nearly a fifth (18 per cent) of people are likely to take risks with their health over and above any other area of their life. This was twice the number who would take a risk with their money, with people equally cautious when it comes to taking a risk with their career (both 9 per cent). When it comes to money, the study also showed that gender and age play a part, with men being nearly twice as likely to take a risk with their finances than women. Additionally, the younger generations (18-34) are the most cautious with their money, despite having the time to be risky, while 35-44 year olds are the most "risky" age group.

While these studies focused more on the retail side of things, they are nonetheless indicative of the fact that all investors need to have a relatively sophisticated awareness of the complex balancing act which the risk/return trade-off entails. While investors today might be understandably reluctant to be cavalier with risk, they need to be aware that some level of risk is unavoidable if they are to make a good return on an initial investment and that knee-jerk reactions to (reasonable) risks are to be avoided.

What this may boil down to is, again, a communications issue. Over recent years several senior industry figures have pointed to the fact that advisors and clients might on some occasions be "talking at crossed purposes." To quote just one recent example, earlier this year John Thiel, head of the US wealth management group at Merrill Lynch told a US conference that clients want simple questions answered about maintaining their lifestyles while advisors tend to speak about investment performance against benchmarks and use jargon like "alpha" and "beta."

"I'm convinced that we still don't speak to the clients the way that they prefer to be spoken to," he was quoted by *Reuters* as having said.

## BNY MELLON TACKLES THE SPECTRE OF RISK IN POWERFUL ADVERTISING CAMPAIGN

The widespread losses which came about amid the maelstrom of the financial crisis, and the ongoing economic uncertainty, means that risk is higher on clients' agendas than ever. Rather than treating investment risk as a "taboo" subject, BNY Mellon has actually opted to make risk the focus of a US marketing campaign where the firm positions itself as an expert in assessing the true risk levels in clients' portfolios.

Cleverly, the firm gives some hard-hitting figures on the weaknesses it uncovered in a sample of 3,000 portfolios it analysed between 2007 and 2011, posing such questions as "did you know that 80 per cent of portfolios carry unnecessary or unknown risk?"

The investor is confronted by the fact that, according to

BNY Mellon's analysis, 99 per cent of portfolios have "hidden risks" and is then invited to let the firm investigate their portfolio through a "2020 Risk Audit." The benefits of lead generation here need hardly be mentioned but also as important is BNY Mellon's positioning of itself as a proactive tackler of the issue of risk and a thought-leader in this area – in effect a "judge" of its competitors.

BNY Mellon also ran a TV advertising campaign which used the powerful visual metaphor of a family home disintegrating like a "house of cards" to get across the idea of hidden portfolio risk needing to be uncovered (lest family security be undermined). The interrogative strapline "Who's helping you?" underlines its positioning as a client-centric firm ready to cast a expert eye over the efforts of its peers.

# What's that ticking sound in your portfolio?

No one can fully predict tomorrow's risks. But in today's fundamentally changed investment world, the risks are less foreseeable and more misunderstood than ever — and can cause lasting damage.

In the thousands of investment portfolios we have reviewed, we have discovered hidden risks in 99% of them.

Wondering if your portfolio is in the rare 1%? Find out with our complimentary, confidential 2020 Risk Audit<sup>SM</sup>.

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## >> SECTION 02 <<

# Changing Risk-Profiling Methodologies

*"Risk-profiling methodologies have naturally altered over the course of time. The more significant movement over time has been in terms of approach and ideology. It is our view that this shift has been more ideological, as risk is not merely a measure of volatility and growth, but is also intrinsically linked to client objectives and future plans" – Suzanne Spink, UK head of Global Investment Solutions at Deutsche Bank Private Wealth Management*

The senior executives involved on this report unanimously agreed that over the course of their careers there had been significant changes to the risk-profiling methodologies used by wealth management firms. Much of the reason for this change has been the need to improve the risk-profiling methodology for assessing risk and suitability for when it comes to recommending investment products to clients. The financial crisis – and the painful losses many endured as a result – has arguably made clients much more aware that "worst-case" scenarios do sometimes come to pass, and that the familiar caveat that "the value of your investment can go down as well as up investments can go down as well as up" is a *real* warning.

Advisors are certainly reporting that risk is far more "front of mind" for clients; 58 per cent of respondents to the reader survey said that clients are bringing up the issue of risk more now than before the crisis.

Although there is still a lot of room for improvement in the industry's approach to risk-profiling (as will be discussed) we should not lose sight of the fact that great improvements have already been made and the days of simple "caveat emptor" have long since passed. As Graham Bentley, head of proposition at Skandia, noted: "Detailed risk-profiling didn't exist pre-dotcom collapse. Calibration with a point on an efficient frontier was revolutionary at retail level."

### A wider view of risk

The biggest change on the risk front has of course been a shift from just looking at product risk to a desire to taking a wider view of client suitability. "If you go back historically, the industry had a different view of risk which could be characterised as predominantly product risk and this varied considerably in standards across the various private banks and wealth managers," said Ian Woodhouse of PwC.

This status quo started to change with the onset of the financial crisis when investors started to experience problems with investments like auction rate securities and bonds and this led to renewed emphasis on product *and* client risk, he continued. This point was echoed by Gary Tiernan of Standard Chartered Private Bank, who said "the impact has

been on risk-rating of clients themselves as well as of the products that are offered to them."

The financial crisis and the resultant ratcheting up of regulatory oversight essentially brought about a "forced upgrade" in the industry's attitudes towards risk-profiling. This positive evolution is certainly a welcome development, the contributors to this report agreed, despite the fact that it might have taken a combination of the crisis and regulators to force the industry's hand.

### Attitudinal shifts

As Tracy Maeter of RBC Wealth Management noted, the formalisation of risk-profiling is one of the most positive developments to have occurred in recent years. In her view, while the concept of risk-profiling has been pretty well embedded in the wealth management and private banking industry for some time, only recently has its application started coming up to scratch. As well as a move away from an "ad hoc" way of doing things, she also pointed to "a marked improvement in the documentation of client risk-profiling so that it can be better quantified."

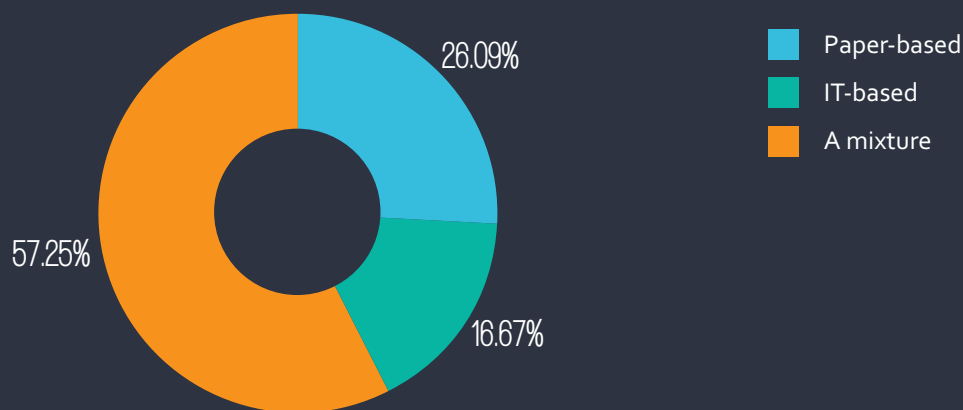
"Client risk-profiling has definitely changed, with a desire to be more thorough in how to deal with the issue," said Tiernan, and in fact most of the senior executives who contributed to this research highlighted an attitudinal shift having taken place in recent years which looks at risk *in context*.

"Risk-profiling methodologies have naturally altered over the course of time. The more significant movement over time has been in terms of approach and ideology," said Suzanne Spink of Deutsche Bank Private Wealth Management. "It is our view that this shift has been more ideological, as risk is not merely a measure of volatility and growth, but is also intrinsically linked to client objectives and future plans."

### Qualitative versus quantitative approaches

But while there may be a more pronounced desire to be thorough, this is manifesting itself differently at different firms, with considerable variance in terms of weighting given to quantitative or qualitative data. Firms are also deploying a mixture of risk-profiling methodologies, as borne out by the reader survey: 26 per cent of respondents said that their firm's approach is paper-based, while 17 per cent favour IT-based methods. However, a resounding majority of 57 per cent reported that a mixture of paper- and IT-based risk-profiling processes are used at their institution.

## WHAT METHODOLOGY IS USED AT YOUR FIRM TO CARRY OUT THE RISK-PROFILING PROCESS WHEN ONBOARDING NEW CLIENTS?



There has however been a noticeable shift recently towards more IT-led processes for client risk-profiling as part of an industry-wide efficiency drive, the contributors to this report noted.

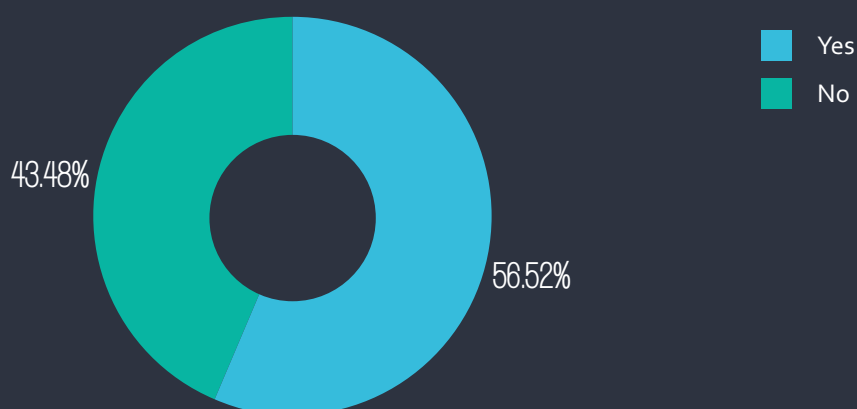
#### How are firms changing their risk-profiling processes in light of regulatory pressures?

Upgrading risk-profiling processes is clearly a priority for the majority of firms: 57 per cent of respondents to the reader survey said that their firm had changed its risk-profiling processes recently in light of regulatory pressures such as the Markets in Financial Instruments Directive.

The respondents to the reader survey were also asked to describe the changes which had been made to their employer's risk-profiling processes. One wrote simply that their firm's risk-profiling process has "doubled in length", with many others saying that a far greater level of detail is now required. Another common theme was that the process now covers risk tolerance, risk appetite and risk capacity in greater depth. Here is a sample of other responses:

- "Clients are now asked to verify all new account information, their investment objectives and financial situation."
- "We have put in place a wider range of questions on investment objectives."

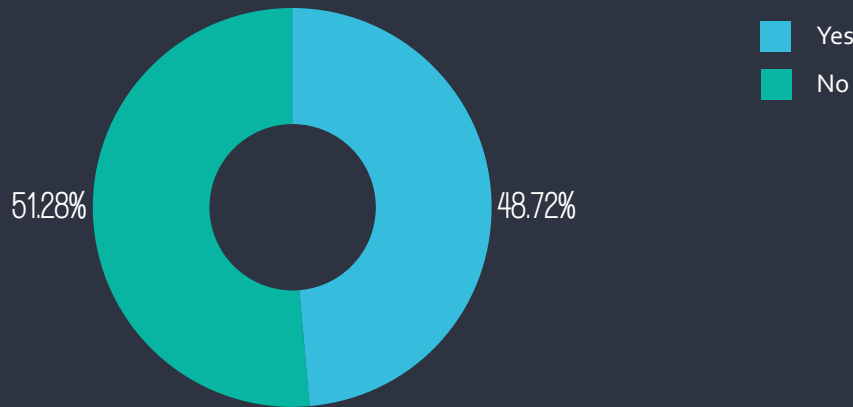
## HAS YOUR FIRM ALTERED ITS CLIENT RISK-PROFILING PROCESS RECENTLY IN RESPONSE TO REGULATORY PRESSURES SUCH AS MIFID?



Changes are also yet to come at just under half of firms: 49 per cent of the wealth managers surveyed said that their firm will be changing its risk-profiling processes in the near future in light of regulatory changes.

- "There is more emphasis on clients' understanding."
- "We have put in place a MiFID-compliant sales process that includes a risk-profiling tool and a set of documentation intended to evidence

### DOES YOUR FIRM PLAN TO CHANGE ITS CLIENT RISK PROFILING PROCESS IN THE NEAR FUTURE IN LIGHT OF REGULATORY CHANGES?



firstly that clients have been assigned a risk profile (conservative/balanced/dynamic) and secondly that clients have *accepted* the risk profile in question."

- "There have been changes in the type and wording of questions for obtaining the information requested for the assessment of clients in relation to their risk appetite, the investment services provided and financial instruments."
- "We've added additional questions to understand the client's previous experience in trading or holding investments and to explain to the client the risks associated with each asset class."
- "Demonstrating that we are re-profiling clients on an ongoing basis is now a core competence."
- "Documentary support for *why* investment recommendations have been made is now compulsory."
- "Suitability is now seen as more of an ongoing consideration."

A large number of respondents also said that their firm had enlisted an outsourced provider to help make their risk-profiling processes more robust, while many others said that their employer had put new software systems in place.

For their part, the expert panel broadly reported that their firms had

made changes (some wide-reaching) to their risk-profiling processes in recent years and most indicated that further enhancements would likely be made in line with regulatory developments and client requirements.

The following is an anonymised sample of the changes which the panel members said had been made to their own firms' risk-profiling processes:

- "We have been focusing in particular on improving our processes to make sure that the nuances and history behind clients' preferences is completely captured, recorded and agreed with the clients directly."
- "Following the FSA report *Assessing Suitability*, we redrafted the risk profiler to remove perceived ambiguity and complexity in the language used. We added a preamble explaining volatility, and that a customer unwilling to take any risk should not complete the profiler. We also created a document called *Understanding Risk* that covers wider aspects e.g. diversification, interest rate, credit and inflation risk, counterparty risk, etc."
- "We set up an enhanced process within the last two years and are comfortable with how we are interacting with clients to jointly agree on the appropriate profiles. However, as we operate in multiple markets we are always obliged to consider and respond to any country-specific changes."

## A MIXED METHODOLOGY IS KEY

IAN STOTT, CLIENT SERVICES DIRECTOR AT THE CONSULTING CONSORTIUM, GIVES HIS VIEWS ON WHAT CONSTITUTES BEST PRACTICE WHEN IT COMES TO RISK-PROFILING CLIENTS

For Ian Stott, the various methods of assessing clients' attitudes towards risk all have inherent weaknesses which mean that it is essential that firms draw on a range of methodologies to get a complete picture of the levels of risk that a client is willing – and able – to take on.

As previously mentioned in this report, many firms are still upgrading their risk-profiling processes in response to regulatory pressures, with some having to grapple with legacy systems even as they install new technologies. The picture at most firms is then very complex, but a really helpful exercise is to consider what a new entrant to the market could do to make their risk-profiling processes truly “best of breed,” says Stott.

### A “three-pronged attack”

In his view, given a “blank piece of paper” a new wealth management firm should be looking to draw on several sources of information and use a real mixture of methodologies when carrying out client risk-profiling. Suitability and Know Your Client information should be taken as “baseline” which is then ameliorated by a “three-pronged attack” of additional assessment. The first of these “prongs” is the traditional risk-profiling questionnaire, which he views as still very important, and the second is behavioural finance or psychometric testing, which he thinks “can produce good outcomes, but not if used in isolation.” However, the third and most important element of the mix is holistic questioning, says Stott.

Ongoing discussions and in-depth questioning around all facets of a client's circumstances are doubtless key to really accurate risk-profiling, the contributors to this report agree. But Stott also made the important point that holistic questioning has one attribute that even the most sophisticated questionnaires or psychometric tests lack: the human touch. As he points out, a person can read facial expressions and other body language and these subtle cues might be far more revealing than a test score on a standardised test. “It's much easier to spot confusion when a person is sat down opposite you than from a list of ten questions,” he points out.

However, this need for the human touch is very much a double-edged sword, he concedes: the advisor's skill is crucial and wealth managers need to have a firm grasp on the strengths and weaknesses of their staff in the context of their own business practices. “Not all advisors are made the same; there will be varying levels of skill and some will just be better at the holistic questioning than others,” he says.

### “Know thyself”

In his view, what firms need to do is to take their duty of care towards clients extremely seriously, “fully appreciate where the business risks of getting it wrong lie” and build their processes around these considerations. An important part of this could be putting “systems and controls in place around some advisors who are known not to be as emotionally competent as others”, he says. On the other hand, some advisors are very talented at the kind of empathetic “digging” risk-profiling requires and their talents should certainly be used to the full. In fact, Stott can envisage a scenario where an institution could draw on the skills of designated risk-profiling specialists as part of a team banking approach.

For Stott, it is the flexibility of holistic questioning which is key to really

accurate risk-profiling – you never know where a conversation may lead and this is often when important details come out. “There isn't one-size fits all in terms of a perfect scenario. What seems like a minor question with one client might turn out to be major question with another, depending on their level of sophistication and understanding of investments,” he says.

He also echoed a point made elsewhere by Tracy Maeter of RBC Wealth Management, in saying that it is entirely possible (if not likely) that clients will have multiple risk-profiles for different “pots” of money, such as those for retirement, an additional property, their children's education and so on. “Clients are constantly chasing different things over different time horizons,” he points out, adding that it would not be “particularly difficult” for wealth managers to treat risk-profiling in silos in line with clients' various goals.

### Evidencing: a major stumbling block

Some firms may be taking an overly simplistic view of risk-profiling in some instances, but in Stott's view the industry in general is falling down in one key area: evidencing and matching risk-profiling data to the investments recommended.

“The business risk lies first in being able to evidence back to clients that you really do understand their attitude to risk, capacity for loss and tolerance, and then secondly the real challenge is being able to document that,” he says.

### The “follow through”

One of the trickier parts of risk-profiling is of course distilling what transpires in lengthy holistic conversations into useable documentation, but what is even harder is following through with this information once captured, says Stott.

Capturing and storing information from “fact find” or personal financial assessment documents is one thing, but translating that information into the generation of investment propositions and suitability reports is quite another, he says. In his view, this “feeding through” of information represents the real risk-profiling challenge and suitability reports are where many firms should be focusing their efforts. “Suitability reports are the primary client-facing document... the advice will stand or fall on the basis of what's contained in that document,” he said.

“Wealth managers have a responsibility to their client's to ensure that they follow the principles/rules laid down in the Conduct of Business sourcebook (COBS) 9.2.1R which 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 and their risk profile and to ensure they are able financially to bear any related investment risks consistent with their investment objectives,” he continued.

“It is still the case that many wealth managers do not yet fully understand the implications of being unable to evidence their understanding of a client's risk profile... however that might be determined or described.”

## UK REGULATOR WARNS OF “SIGNIFICANT, WIDESPREAD FAILINGS” ON SUITABILITY

In the summer of 2011 the Financial Services Authority sent a firm message to the UK wealth management sector to ensure that clients are sold suitable investment products for their risk appetites and objectives in the form of a “Dear CEO” letter sent to hundreds of institutions of all stripes.

Having conducted a suitability review of 16 unidentified firms the UK regulator concluded that 14 of them posed a “high” or “medium” risk to clients due to unsuitable portfolios. Among the failings were a lack of basic KYC information; inadequate risk-profiling; lack of data on clients’ financial situation, and inconsistency between a portfolio and client’s attitude to risk, the FSA said.

Having reviewed a sample, the regulator concluded that 79 per cent of the portfolio files it had examined had either shown “high risk” of unsuitability, or that their suitability could not be determined. More than two-thirds (67 per cent) of the files reviewed were “not consistent with one or more of the following: the firm’s house models; the client’s documented attitude to risk; and the client’s investment objectives”, the FSA said.

### Good housekeeping

As a result of the review the regulator urged the industry to *demonstrate* that it was putting clients into suitable investment products - underscoring the need for firms not only to perform the necessary assessments but also to assiduously keep records to *prove* that they have done so.

In fact, the FSA made its stance on the need for this kind of careful “housekeeping” even clearer in its March 2012 *Retail Conduct Risk Outlook* report:

“We have carried out a thematic review in the wealth management sector, which revealed evidence of misconduct, giving rise to potential consumer detriment. *In particular, the results indicate that many firms do not gather or maintain adequate client information to demonstrate suitability*, and that even where the information is available, there is a significant risk that consumers have unsuitable portfolios.”

While the FSA may be losing some of its key banking regulation roles to the Bank of England under government reforms, it has nonetheless been flexing its muscles strenuously in recent times, imposing almost £100 million of penalties in the 2010-11 financial year – hitting some of the world’s biggest firms with hefty fines for lapses including the mis-selling of funds.

The regulator is also clearly determined to cast its net far and wide as although it only reviewed a sample of 16 wealth management firms the June 2011 “Dear CEO” letter was sent to some 260.

“We have identified significant, widespread failings, which we are concerned may also be prevalent in firms outside our sample,” the FSA said.

Sounding an even more ominous note, the regulator’s latest *Retail Conduct Risk Outlook* report said: “We are concerned that poor firm

conduct in private banking and wealth management might lead to widespread detriment.”

### Specific product concerns

The FSA is particularly worried that wealth managers are putting clients into excessively risky or over-complex products as they struggle to continue to deliver the wide range of bespoke services HNW clients expect in an increasingly tough operating environment of low interest rates and (ironically) increasing compliance costs. These factors can encourage firms to sell investors products that target higher levels of return without understanding or disclosing the risks, the FSA has said, warning that “it is particularly important, when banks decide to grow their wealth management business, that they have continued regard to their Treating Customers Fairly obligations.”

The regulator has noted that some wealth management products were initially designed to be sold to institutional clients and in consequence could feature greater complexity than private clients are used to. It warned in the 2012 *Retail Conduct Risk Outlook* that poor assessment of clients’ attitudes to risk may have resulted in the “up-risking” of some clients, leading to a “significant risk” of investors being sold unsuitable products or portfolios.

Products coming under particular scrutiny from the FSA include traded-life policies – a relatively esoteric investment where a client “bets” on when a particular set of individuals will die, purchasing a TLP from its owner prior to the policy’s expiry date at a discount. The investor will then hope to sell the policy for a profit if the beneficial owner of said policy dies at or before a certain date. However, if the original beneficial owners of the policy live longer than actuaries expect, the investment, so the FSA fears, may not function as hoped.

The FSA is concerned that such attempts to profit from longevity risk are too risky for all but the most sophisticated investors and professionals. As Margaret Cole, managing director of the regulator, stridently put it: “TLPs are toxic products which pose significant risks for retail investors.”

The FSA has also hit out at the mushrooming supply of exchange-traded products, saying that some are riskier than they first appear as they can be complex in structure, such as in the case of “synthetic” ETPs which use swaps to replicate returns from a specific market, rather than holding the underlying shares in an index.

There are of course several ideological issues at stake here, not least the difficulty of verifying how “sophisticated” an investor is; size of assets is clearly no reliable benchmark and it should be noted that even the brightest whizzkids in the financial services space can sometimes get things very wrong. In fact, several industry commentators have suggested that the regulator should help the industry by giving a clearer notion of what its test for “sophistication” is.

Industry figures also warn against the dangers of over-protecting investors on the basis that if the FSA takes issue with products that may not behave as expected then it may as well ban retail investors from *any* product.



## &gt;&gt; SECTION 03 &lt;&lt;

## Record-Keeping: Room For Improvement

*"One way that the industry could improve further would be to ensure that all client-facing professionals realise the importance of record-keeping by including it as part of their performance criteria. This helps turn it into more of a behavioural issue and moves it away from merely being a requirement exercise for the sake of the regulators" – Tracy Maeter, head of investments for the British Isles at RBC Wealth Management*

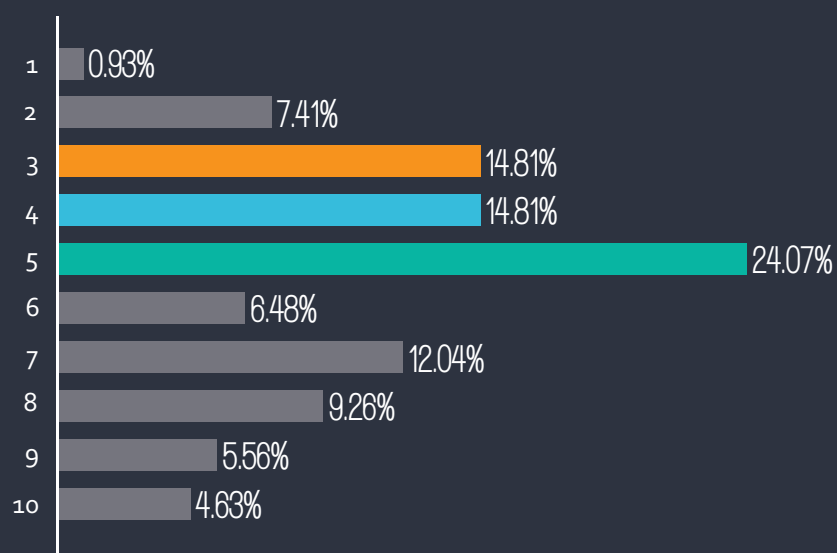
There seems to be a widespread recognition that there is room for improvement in the wealth management industry's record-keeping practices. When asked to rate (on a scale of one to ten) how good they thought the industry's record-keeping was for all of the client information relevant to risk-profiling, the majority of the respondents to the reader survey broadly indicated that they thought firms' processes are average at best.

As several contributors pointed out, the wealth management industry has historically perhaps not been the best at record-keeping (and not just with regards to risk-profiling). "Record-keeping in the industry in general has been poor and this is an area of improvement focus for many participants as regulators place increased emphasis on this area," said Ian Woodhouse of PwC. It is arguably the case however that poor record-keeping in the industry has been the product of its client-centricity and focus on discretion rather than any embedded recalcitrance. However, as regulators step up their oversight across the wealth management piece and firms themselves look to mitigate so-called "key man risk" it is certain that the systematic storage of all manner of client information will continue to improve.

There is no doubt that record-keeping related to risk-profiling is an area of heightened focus for regulators such as the UK's Financial Services Authority and Switzerland's FINMA, and that firms are busily

ON A SCALE OF ONE TO TEN, INDUSTRY-WIDE, DO YOU THINK THAT THE RECORD-KEEPING FOR ALL THE CLIENT INFORMATION RELEVANT TO RISK-PROFILING IS GOOD? (I.E. IS IT USED OPTIMALLY TO THE BENEFIT OF BOTH CLIENTS AND THEIR WEALTH MANAGERS?)

1 - Completely disagree  
10 - Completely agree



The majority of respondents (24 per cent) put the record-keeping of the wealth management industry with respect to client risk-profiling at a five out of ten. In total those rating the industry's record-keeping as poor to average totalled 62 per cent, while just 5 per cent of respondents gave the industry a rating of ten out of ten.

The expert editorial panel members who contributed to this report were largely in agreement that the industry has some way to go in the quality of its record-keeping – but they also noted that things have been improving in recent years.

improving their record-keeping procedures in response. "I think if we're honest about ourselves as an industry we have been less than perfect in this regard in the past, which is why regulators are looking so closely at the issue," said Tracy Maeter of RBC Wealth Management.

## Improved "housekeeping"

As mentioned elsewhere in this report, the UK regulator has been vocal in urging the wealth management industry to *demonstrate* that it is putting clients into suitable investment products by assiduously



keeping records of all information related to risk-profiling.

In its March 2012 *Retail Conduct Risk Outlook* the FSA said:

"We have carried out a thematic review in the wealth management sector, which revealed evidence of misconduct, giving rise to potential consumer detriment. *In particular, the results indicate that many firms do not gather or maintain adequate client information to demonstrate suitability*, and that even where the information is available, there is a significant risk that consumers have unsuitable portfolios."

For Bruce Weatherill, chief executive of Weatherill Consulting, there are several areas of weakness in the industry's record-keeping practices when it comes to client risk-profiling. In his view, a firm's "audit trail" may be weak for various reasons, including the fact that multiple systems could be in use (particularly as a result of acquisitions of firms/teams) and that technology in general has been underused. He also notes that the regulatory requirements on record-keeping seem to get ever higher and so this then creates a legacy issue for firms' existing clients.

Daryl Roxburgh of BITA Risk agrees with Weatherill that technology has been broadly underused in the industry when it comes to keeping records of all the information relevant to risk-profiling and that advisory processes haven't been as good as they could be as a result. "In discussions with potential client firms we generally find that client risk-profiling information is very often just filed in paper form and not integrated with the management of the client account," he said, adding that even if firms can demonstrate that they keep records well if they are not integrated into account management then there is little benefit to either the firm or client.

That record-keeping needs to be geared towards the benefit of the client rather than just being about the audit trail was highlighted by several members of the expert panel. Echoing the title of this report, they cautioned that record-keeping needs to be about more than firms "covering their backs" by ticking regulatory boxes. Graham Bentley of Skandia warned that written records of the risk discussion may be "cursory where they are seen as protection for the advisor rather than as for the benefit of the customer."

The expert panel also emphasised the need for record-keeping to be kept "live", as it were, and that rather than being filed away merely to prove regulatory compliance records should form an intrinsic part of the ongoing advisory process – that is, data related to risk-profiling should be easy for advisors to access and regularly revisited (most saying at least once a year).

"Record keeping is extremely important for ongoing awareness of appropriate risk-profiling. The maintenance of the data in an easy-to-access system helps advisors to support their clients most effectively," said Gary Tiernan of Standard Chartered Private Bank.

BITA Risk's Roxburgh believes that the key to using record-keeping for the benefit of clients lies in using the data collected throughout the risk-profiling process in an "integrated and proactive way". BITA Risk – along with other technology providers – is aiming to help firms to make the best use of this data by integrating risk-profiling and portfolio monitoring applications with front-office systems. Such technology-led approaches proactively give feedback to advisors by linking client mandates and profiles with their actual portfolio characteristics.

Full integration of risk-profiling data with client relationship

management systems is now what many firms are moving towards, however the contributors to this report also pointed out that despite a more tech-led approach the emphasis should still be on gathering *qualitative* information and that detail is key.

### Qualitative information is key

"Industry-wide there is a tendency to reduce profiling data to a few simplistic 'scores', without retaining the underlying data and understanding of each component. Defining a suitable investment process requires a high-resolution picture of each client's individual needs, attitudes, and circumstances. Each piece of this picture can have independent implications for the optimal solution, and yet only rarely is this level of detail retained and utilised," said Greg Davies of Barclays.

Martin O'Hare, managing director and head of investment solutions at Signia Wealth, echoed the point that a deep level of knowledge about a client's circumstances and attitudes is what matters and that while increased oversight is an irreversible trend (which has driven improvements), regulators should avoid over-burdening firms and fostering a "box-ticking" mentality.

"I think there is a danger that many firms will be focusing too much on the optics (i.e. being able to show or prove to the regulator that the necessary steps have been taken, which is a mammoth task at many firms). More attention needs to be focused on the qualitative and value-added aspect, which is ensuring a deep level of knowledge on all aspects of a client's financial affairs and attitudes to risk, before making recommendations," he said.

"Too much paperwork and wealth managers will be overburdened with costs (i.e. too much red tape), so a balance needs to be found that, firstly, is optimal to clients but, secondly, allows firms to function properly and focus on the clients and less specifically on building up the paper trail."

### A cultural shift

Several of the expert panel members suggested that what is needed is actually more of a cultural shift, among regulators, firms and advisors themselves, which recasts good record-keeping as central to best practice, rather than an administrative burden.

"One way that the industry could improve further would be to ensure that all client-facing professionals realise the importance of record-keeping by including it as part of their performance criteria. This helps turn it into more of a behavioural issue and moves it away from merely being a requirement exercise for the sake of the regulators," said RBC Wealth Management's Maeter. This sentiment was echoed by the respondents to the reader survey, one of whom said: "Much greater training is required for financial advisors to understand the commercial benefits of risk-profiling."

In fact, the business benefits which come from having excellent record-keeping systems in place was a theme which was brought up repeatedly by the respondents to the reader survey. One professional, looking at the issue from sales management/business development perspective, said: "Trust is earned by relationship managers and firms over years not months. Being able to demonstrate robust and sophisticated systems should increase the ability of private clients to trust wealth management organisations (and the pace at which they do so), which in turn improves the conversion rate of new business – something which is top of every wealth management firm's business plan for 2012."

## TRANSFORMATIONAL TIMES: WHAT STARTED AS GOOD PRACTICE AND PROCESS HAS NOW BECOME MANDATORY

*TOM BURROUGHES, WEALTHBRIEFING GROUP EDITOR, TALKS TO DARYL ROXBURGH, GLOBAL HEAD OF BITA RISK, ABOUT THE INTRICACIES OF RISK-PROFILING*

### How would you best describe BITA Risk, what the firm does and where it fits into the wider management industry?

Roxburgh: BITA Risk provides a range of private client risk-profiling and suitability assessment tools that enable private client investment firms to profile, assess, monitor and report client suitability. Based on sound business understanding, these tools are designed to complement the investment and business processes of client firms. Processes vary significantly between firms and BITA Risk has maintained its tradition, established in servicing the institutional investment world, of configuring its applications to the needs of each firm - rather than a one-size-fits-all approach. As investment firms strive to keep abreast of regulatory examination and investors gain a greater awareness of the investment management process, using products that give competence in the sales process, client suitability and understanding, and governance of portfolio suitability can deliver a significant competitive edge.

### How important is the area that BITA Risk works in, and why?

Roxburgh: Before the regulators' more recent focus on assessing suitability, BITA Risk believed a common understanding of risk between the client and their investment manager was key to the relationship and managing expectations. Providing an application that delivered this consistently and gave the client insight into the investment risks in an efficient and consistent way would be beneficial for both firm and client. We are now witnessing a clear regulatory demand and appetite for a more rigorous approach to client risk assessment and monitoring; what started as good practice and process has now become mandatory. We believe that transparency and understanding brought about through clear explanation is vital to setting and meeting client expectations. The trend for a more thorough and transparent approach is becoming global, as regulators adopt common practices and firms see the benefit that this can bring to the sales process.

### What sort of forces drive demand for the services BITA Risk provides?

Roxburgh: Regulatory change has made the case for a "nice to have", "best practice" process, compelling. Firms' desire to improve their sales process and ensure consistency of approach and quality, and governance processes such as the monitoring of portfolios against mandate have also driven demand. In the UK, the Treating Customers Fairly and Assessing Suitability guidance, and the anticipated introduction of the Retail Distribution Review have led to growing compliance scrutiny. Increasingly sophisticated investors are also expecting more, all of which are key forces driving the uptake of BITA Risk's services.

### What has been the kind of event that has driven demand for BITA Risk's services since its founding?

Roxburgh: Given that BITA Risk is now in its twentieth year, there have been many events that have driven demand - not all of which have been positive. In the early noughties the dotcom collapse

and 9/11 hit the quant industry hard and a number of teams that we supplied services to disappeared. Individuals who had used our institutional applications began to re-emerge after a period to take up our services again. More recently, periods of market volatility have made private client firms think more about risk monitoring and our services.

The Suitability Guidance and "Dear CEO" letter issued by the FSA in June 2011 which identified "significant and widespread failings" amongst investment firms as a result of their wealth management review has also meant that a fully rigorous and transparent approach to assessing client risk is becoming a prerequisite.

### What sort of clients do you have?

Roxburgh: BITA Risk applications are used in over 100 offices in 14 different countries; our clients range from family offices and boutique investment houses, through to large wealth management firms and private banks with offices around the world. BITA Risk's applications are also used by a number of CIO and quant investment teams.

### Broadly, how do BITA Risk's products work?

Roxburgh: BITA Risk offers a range of software-based applications that can be applied to the entire investment cycle and help firms develop practical processes for assessing, addressing and managing risk in the private wealth environment. BITA Risk's tools help firms educate and work with their clients in appropriate portfolio construction and ensure that the suitability and assessment process is not simply a box-ticking process. The tools are easy to implement and allow for modular elements to be taken by any firm.

### What do you think about behavioural economics and the interest around it? How can such insights be applied on the ground?

Roxburgh: As with most mainstream approaches that aim to explain market and human behaviour, there is a wealth of academic work and literature supporting and opposing the arguments, and as with many approaches, it can add value to understanding when used in the right circumstances. However, in investments and the field of economics there is no single approach that is right to the exclusion of all others.

Elements of BITA Risk's client risk questionnaire can be considered as behavioural but with a strong focus on utility trade-off and always pertinent to the central point of the questionnaire: what is risk and how could it affect the client? This provides the framework for education and informed debate with the client about what risk is and how it could impact them. Abstract questionnaires - whether psychometric or behavioural - cannot educate the client in risk, nor form the basis of a risk discussion. Feedback we have received from some client firms is that clients perceive them as trivial without direct relevance to their portfolio and with little or no transparency in connecting their answers to the characteristics of the end investments.

## >> SECTION 04 <<

# How Accurate Are Risk-Profiling Questionnaires?

*"It is important that the questionnaires used are part of the process to understand a client's willingness to accept risk, rather than determining the outcome" – Richard Anderson, head of wealth planning and Retail Distribution Review at Lloyds TSB Private Banking*

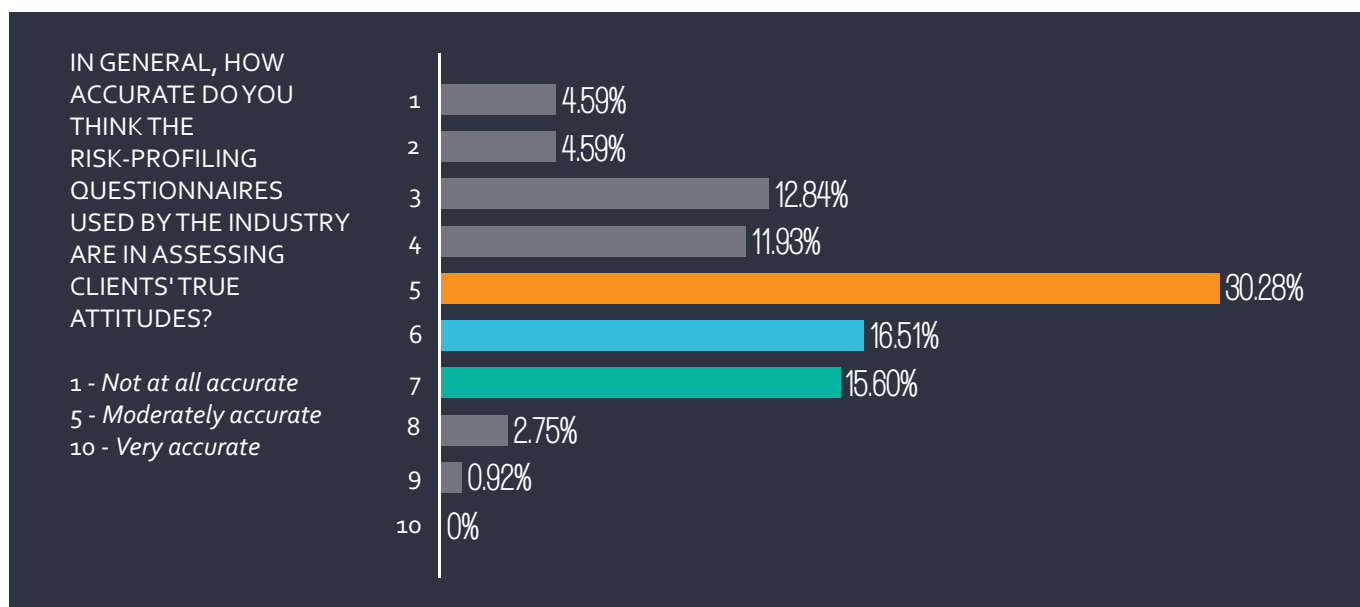
Wealth management professionals believe that the industry's client risk-profiling questionnaires are pretty average in terms of their accuracy, according to the reader survey. The majority (30 per cent) of respondents placed the accuracy of the industry's client risk-profiling processes at a 5 on a 10-point scale while overall 87 per cent of those surveyed gave an accuracy rating of between 3 and 7. None of the respondents said that the industry was delivering a 10/10 when it comes to the accuracy of its risk-profiling methods, but few (less than 10 per cent) participants gave a very poor score of 1 or 2.

### Variable standards

It should be noted that the respondents to the reader survey were being asked to assess the industry in general, and it could be said that the results reflect the fact that there is significant variation in the risk-profiling approaches seen across the industry – although most firms are making efforts to further improve.

"A lot of effort is going into improving the risk-profiling questionnaires and so they are becoming better in assessing clients' attitudes to risk, however, the standards are still variable across industry participants. We expect upgrading of risk-profiling to be major focus in the next year," said Ian Woodhouse of PwC.

This sentiment was echoed by Benjamin Manz, managing partner at



These results would seem to confirm the views of the expert panel, who said that while progress has been made the industry still has a way to go in accurately assessing its clients' attitudes towards risk, their capacity for it and – crucially – their understanding of it.

The panel members were united in viewing the introduction of risk-profiling questionnaires as a positive step, but they also cautioned that questionnaires and other risk-profiling tools should not be solely relied upon.

Assetinum, who said of Switzerland: "As far as we can see, there are big differences in the Swiss industry regarding risk-profiling.

Questionnaires differ from provider to provider - quite a few asset and wealth managers don't even have any standardised questionnaires." However, as he points out, this variation is not down to just carelessness, but also the fact that firms vary widely in terms of their investment philosophies.

In tackling this variation across the industry, it was suggested that perhaps regulators could be more prescriptive about what constitutes best practice when it comes to assessing how much investment risk clients are willing and able to take on. This is however clearly an area regulatory bodies are looking at: new regulations from FINMA, the Swiss regulator, seek to standardise risk-profiling techniques, while the UK's FSA has produced guidance highlighting the risks and weaknesses of different approaches.

### Understanding the question

For their part, the expert contributors to this report were all very vocal on the fact that risk-profiling questionnaires and other tools can only ever be "the start of the story", for various reasons.

One of the first issues raised by the expert panel was that the accuracy of risk-profiling questionnaires and other tools is dependent on clients' understanding – and that this is often overestimated by advisors.

"I do not believe they [risk-profiling questionnaires] are particularly accurate as they rely on the simple basis that clients fully understand the questions and that is not always the case," said Martin O'Hare of Signia Wealth.

Bruce Weatherill of Weatherill Consulting echoed this point, while also highlighting a need for both institutions and advisors to take on more of an educative role. "On the whole, the industry has done itself no favours by using very simplistic methodologies delivered or explained by not particularly well-trained staff," he said. His point about the dangers of over-simplification was in fact one which came up repeatedly.

### Multiple risk-profiles

For Tracy Maeter of RBC Wealth Management, another fundamental weakness of risk-profiling questionnaires is that they assume that clients have a sole, unified risk-profile for all their financial affairs, and in this isn't necessarily the case.

"It should also always be remembered that many private clients are more complex than just having one single risk profile. Clients often compartmentalise their objectives - they think differently about pensions, say, than they do about their children's trusts or a 'rainy day' fund," she said.

In her view, questionnaires simply "can't be expected to pick up these nuances" and this is why the advisor-client conversations which accompany such risk-profiling methodologies are so important.

For Maeter, risk-profiling is done badly when "advisors view the questionnaire as an end in itself, rather than as a tool."

Regulators are also making their reservations known, noted Architas' Caspar Rock. "The January 2011 FSA paper on *Assessing Suitability* was a major catalyst for the reappraisal of risk models by all providers, and a very timely reminder that advisors should only use computer-based processes as *a part* of the of their risk assessment process, not as *a substitute*," he said.

"It also pointed to three specific concerns that needed to be addressed. These were the lack of an assessment of an individual's capacity for loss, the underuse of cash deposits for those unwilling to accept a loss, and the concern that where questionnaires were used, that they were poorly constructed, over-sensitive and could result in conflation or poor interpretation of the outputs."

### Just the start of the risk conversation

That questionnaires should be seen more as a prompt for further detailed conversations rather than a "finished piece of work" in themselves was a recurrent theme in the compilation of this report. As Graham Bentley, head of proposition at Skandia, put it, risk-profiling questionnaires are "for guidance only". "The discussion that follows is the most important element in the process, and the calibration of the resulting portfolio with the customer's ability to tolerate a fall in their portfolio's value," he said.

Several of the expert panel drew the same distinction: that a client's "hypothetical" risk tolerance and their actual ability to tolerate a certain fall in their portfolio can be quite different. Therefore, the results of risk-profiling questionnaires must be augmented by an understanding of clients' wider circumstances, assets, investment experience and underlying motivations. In the words of Suzanne Spink of Deutsche Bank Private Wealth Management, a "robust fact-finding" needs to take place to support questionnaire-type methodologies. "It is only when you obtain a detailed knowledge of a client's circumstances, together with their attitude toward risk and objectives, can one assess a client's true attitudes," she said.

While the expert panel agreed that risk-profiling questionnaires are best thought of as an aid to in-depth discussions on investment risk, several contributors went further and voiced concerns about the underlying validity of questionnaires' results.

For Greg Davies of Barclays, several flaws in prevalent questionnaire-based methodologies mean that the industry's risk-profiling is generally not very accurate. As well as the fact that questionnaires are "very often not designed using rigorous data-driven statistical techniques", he notes that often "they frequently muddle together questions on quite distinct dimensions of risk attitudes, or indeed questions which are not attitudinal at all (such as time horizon) – which has the effect of driving the results towards a generic 'moderate' category."

Looking closer at the question formats which are used, Davies notes that often formats are used which are known to result in "unstable, and frequently pro-cyclical, responses." (For an interview with Davies on Barclays behavioural finance approach to risk-profiling see overleaf).

Davies' main reservation about commonly-used questionnaire methodologies is however more that as human beings "we are not good at making stable hypothetical trade-offs, and we are not good at probabilistic reasoning" – meaning that it's often "almost impossible" for investors to respond meaningfully to questions asking them to indicate preferences between hypothetical portfolios trading off risk and return in the future.

"For example: do you choose portfolio A with an expected return of 10 per cent in five years, but a 15 per cent chance of losing money, or portfolio B with an expected return of 20 per cent in five years, but a 20 per cent chance of losing money," he said.

"At best such questions turn into assessments of financial knowledge, or numeracy, not risk tolerance... at worst they are meaningless and thus dangerous as an input to 'optimal' portfolio selection."

And it is not just questions themselves which can be problematic, as lots of other variables can also influence the results of risk-profiling questionnaires, noted Richard Anderson of Lloyds TSB Private Banking.

"The accuracy of questionnaires will be dependent on a number of variables, including, but not limited to; the questions themselves, any associated scoring mechanisms, the client's attitude and circumstances at the point of answering, the positioning of the questions and the approach taken by the advisor," he said.

Anderson also made the point that it is virtually impossible to iron out all the inconsistencies which may affect questionnaire results. "While it is possible to mitigate the fluctuation in some of these variables it should be accepted that variation will occur, even with the most sophisticated profiling," he said. "With this in mind, it is important that the questionnaires used are part of the process to understand a client's willingness to accept risk, rather than determining the outcome."

This point about being careful when "translating" the findings of risk questionnaire into portfolio construction was picked up by BITA Risk's Daryl Roxburgh who cautioned that as well as checking the results of questionnaires for consistency "there must be a transparent process for aligning the client portfolio with the questionnaire results." As a further step in checking this alignment, Roxburgh proposes that "the expected risk characteristics of the proposed portfolio should then be illustrated to the client so that they are given some understanding of the potential risks they might face."

Clearly illustrating to clients the possible risks a proposed portfolio might represent was held to be important by both the survey respondents and the expert panel – particularly the modelling of "worst-case" scenarios, as will be seen.

## BEHAVIOURAL FINANCE THEORY: GAINING CURRENCY FAST

*GREG DAVIES, MANAGING DIRECTOR AND HEAD OF BEHAVIOURAL AND QUANTITATIVE INVESTMENT PHILOSOPHY AT THE WEALTH AND INVESTMENT MANAGEMENT DIVISION OF BARCLAYS, EXPLAINS WHY BEHAVIOURAL FINANCE IS BECOMING INCREASINGLY MAINSTREAM*

Few good things emerged from the financial crisis, but one of them was a new appreciation of the principles of behavioural finance, according to Barclays' Greg Davies.

Davies, who is somewhat of a figurehead of behavioural finance, has seen a remarkable shift in clients' attitudes towards the discipline over the five years since Barclays adopted this approach.

Barclays formed its behavioural finance unit in December 2006, making it – in Davies' words – the "first firm to do it by a long margin." At that time the level of client awareness was "reasonably low" but since then, spurred by the global financial crisis, these ideas have really started to take root in investors' minds, he says.

### Ideas taking root

The difference has been particularly marked in the Asia-Pacific region, as while US and to a certain extent UK clients already had some exposure to these ideas, in Asia-Pacific behavioural finance was a relatively new topic (a lot of the academic work on the subject came out of the US).

The maelstrom of the financial crisis changed all that, notes Davies. "One of the rather dubious advantages we've had from financial crisis is that it has cast the classical model, which is based on rationality, into significant doubt," he says. "The only area of economics which came out of the crisis looking better than when it went in was behavioural finance because people started to pay much more attention to the role played by emotions and psychology."

Behavioural finance, which is increasingly on the radar of the wealth management industry globally, seeks to debunk the myth of the "Economic Man" (i.e. a hypothetical individual who acts rationally and with complete knowledge, but entirely out of self-interest) and market efficiency. Instead, it focuses more on the biases, habits and crowd mentality of humans in markets.

### Behavioural finance and risk-profiling

Aside from it posing a very interesting counterpoint to classical theory, advocates of behavioural finance believe that its tenets not only provide a framework to unpick the "financial personality" of clients, but that it

can also make a huge difference to their wealth. While the aim is to arrive at a stable, long-term risk profile for clients, regular profiling methodologies often generate something completely different, says Davies. "Done badly, risk-profiling identifies something much more short-term and pro-cyclical and you end up exacerbating people's innate tendency towards buying high and selling low," he says.

Barclays' approach aims to recognise that there is both a rational and emotional side to the story – that while clients may well accept a long-term, stable, underlying, rational trade-off between risk and return (what the firm calls risk tolerance), they could find it emotionally difficult to enact this in the short term.

What needs to be recognised is that "investors find it difficult to get into the market in the first place and then once they are in they have emotional responses to the journey along the way," says Davies.

### Emotional comfort

According to Davies, the problem with regular risk-profiling is that it often fails to recognise the influence of immediate emotional comfort, i.e. the fact that human beings have a powerful urge to feel emotionally comfortable with their portfolios, despite the fact that securing this short-term emotional comfort is often to the detriment of their long-term portfolio efficiency.

With this in mind, Barclays' risk-profiling methodology seeks to gauge clients' "composure" to see how emotionally engaged they are with the short term and also their market engagement level – a measure which looks at how hard investors found it to get out of cash and into investments in the first place.

Without taking on board these three aspects of risk attitude (risk tolerance, composure and market engagement) when risk-profiling clients, Davies believes that wealth managers are "trying to use a really blunt instrument". "Relying only on a single dimension of long-term risk attitude assumes you have to be perfectly rational along the journey. A stable long-term measure of risk tolerance is the right thing to focus on, but only if you supplement this with an understanding of shorter-term emotional attitudes will clients ever get close to their attainable returns in reality," he says.



"Neither of those is ever going to get investors to the right point."

### Avoiding costly errors

Risk-profiling is about far more than ensuring clients feel comfortable with their portfolios (although this is certainly an important consideration) - it's actually about ensuring that clients meet their wealth goals, explains Davies. The way that behavioural finance-based risk-profiling can help is that it creates an investment framework or system for clients, whereby certain "rules" overriding emotional responses to market gyrations become habits.

The costs of not doing so can be punitive, Davies points out.

"That portion of your portfolio where you're sitting on too much cash is probably costing you in the long term 4-5 per cent per year. For the proportion of your wealth that you do have invested, the evidence suggests that the average individual costs themselves 1-2 per cent per year," he says.

"Then the switching between these because you get excited at the top and fearful at the bottom can cost you an enormous amount." Conversely, Davies believes that the financial rewards of investors achieving a "behavioural calm through the journey" can be immense.

"From stopping someone selling at the bottom you're going to achieve improvements in returns in the order of 5, 10, 15 or even 20 per cent in some cases," he says.

### No "magic bullet"

While Davies is a passionate advocate of the behavioural finance approach, he also emphasises that its worth depends entirely on its implementation and it means little if undertaken as a token gesture towards fashionable theory.

Many firms use behavioural finance as a marketing gimmick, when in fact "it needs to be built into the very fabric of the firm," Davies points out, noting that "it's not easy to do it systematically."

Nor is Davies suggesting that behavioural finance is something all clients either want or need. "It depends on their [financial] personality; I won't deny that there are people out there who are just innately better at controlling their emotional response to the short term," he concedes.

That said, the number of firms which are jumping on the behavioural finance bandwagon would suggest that clients are increasingly interested in understanding their own financial personalities and learning to better govern their investment behaviour. At a sophisticated level the approach can even be used to build "emotional insurance" in and smooth over short-term wobbles - what Davies terms "inoculating your portfolio."

Ultimately, behavioural finance-led risk-profiling is about empowering clients and recognising that "we're not robots", says Davies. But there are now also several decades of academic work which suggest that achieving "behavioural calm" is about more than keeping stress levels down - it's also about pushing returns up.

## CLIENTS' RISK TOLERANCE REMAINS REMARKABLY STABLE THROUGH MARKET GYRATIONS

RESEARCH BY FINAMETRICA SUGGESTS THAT CLIENTS' FINANCIAL RISK TOLERANCE IS "A TRAIT AND NOT A STATE"

Although risk tolerance has historically been widely perceived as being very unstable and a function of the pendulum swings of market conditions, studies now suggest that is anything but the case. In fact, according to a recent study by Australian risk-profiling specialist FinaMetrica, clients' risk tolerance scores remained "remarkably stable" through the gyrations of the markets during the crisis - confirming a large body of anecdotal evidence to that effect.

FinaMetrica views the misconception that risk tolerance is unstable as down to the mistaken belief that risk tolerance is the main driver of risk behaviour. Instead, the firm says, risk behaviour is in fact driven by several factors - one important one (in unstable market conditions) being risk perception.

The problem with most research into clients' risk tolerance is that it fails to control for risk perception, according to FinaMetrica. The oft-cited finding that "financial risk tolerance tends to increase when stock returns increase and decrease when stock returns decrease" (Yao, Hanna & Lindamood (2004) analysing the *Survey of Consumer Finance* data) was later revised by the study's authors to conclude that it seems plausible that "the SCF risk tolerance measure is not a stable measure related to risk aversion but instead is an attitude reflecting expectations."

FinaMetrica notes that advisors often say that their clients' risk

tolerance declines significantly in bear markets, a conclusion they come to because clients want to get out of investments they were entirely comfortable with before. Instead FinaMetrica offers an alternative explanation: "that clients were not only over-exposed to risk but also did not understand the risks they were taking until these risks became actuated."

### Over-exposure to risk no surprise

FinaMetrica identifies several factors underlying the fact that clients are often over-exposed to risk:

- Advisors' estimates of their clients' risk tolerance are "highly inaccurate"
- Standard risk questionnaires tend to be biased towards higher risk/return outcomes
- Advisors tend to be far more risk tolerant than their clients

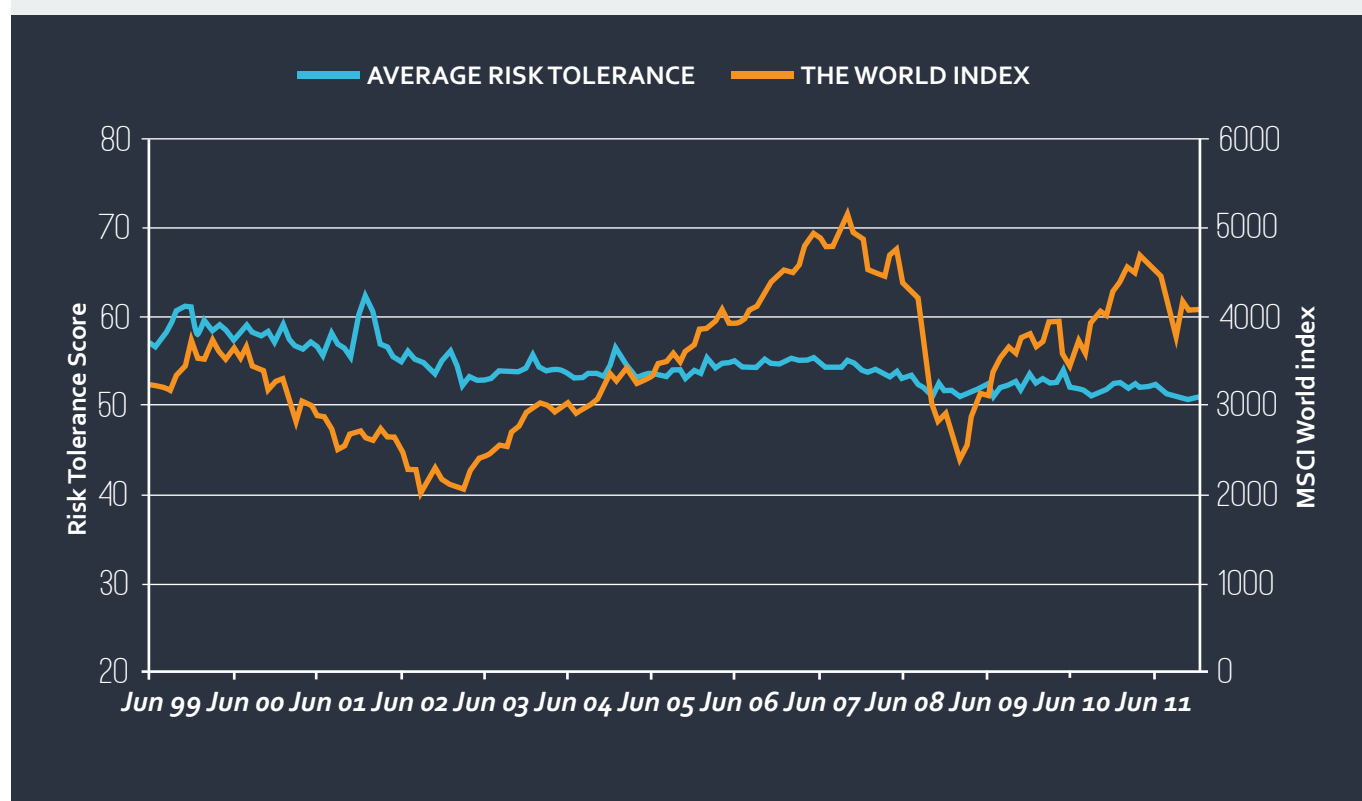
The firm also notes that the industry as a whole tends to provide risk/return illustrations which downplay downside risk (particularly "outlier" events, such as those of the financial crisis) so clients don't tend to completely understand the risk they are taking. The "doom and gloom" picture perpetuated by the media at times of market stress doesn't help either; combined, these factors have led to the mistaken belief that risk tolerance is unstable, the firm says.

### Risk tolerance: "a trait not a state"

FinaMetrica's psychometric risk tolerance analysis rates clients on a 1-100 scale and over the last 13 years has gathered data from 500,000 tests. For its research the firm compared clients' risk tolerance scores to the movements of the MSCI World Index over the same period. As the figure below shows, risk tolerance broadly remained stable despite the fluctuations of the markets over the period.

as such is highly unlikely to fluctuate over the life of an individual."

Even more interesting were the results of a test/retest performed on data from the 2003-2007 bull market and a second focusing on the later bear market. Here it was not clients' risk tolerance which reflected the market change, but rather "there was clearly a change in people's risk perceptions, as indicated by self-assessments." In total there are now six respected studies covering over a decade



As part of the test and retests of this data, one study over eight weeks concluded that: "The increase in financial experience and knowledge, as well as the occurrence of a major stock market crash during the trading period, did not appear to affect the stability of risk tolerance... *It was concluded that financial risk tolerance is better considered as a trait and not a state.*"

Various subsequent studies have found risk tolerance to be "not as transitory as some have thought it to be" and that it "does not appear to be affected by the general economic mood (as measured by a consumer confidence index)", FinaMetrica notes. As such, we come back to the assertion of Hanna and Chen (1997) that "financial risk tolerance is a genetic and predispositional stable personality trait and

which indicate that risk tolerance is a stable psychological trait.

### What does this mean for advisors?

FinaMetrica believes that it's actually good news that risk tolerance is a stable trait, since it then "makes a solid foundation for conversations about risk generally, and portfolio risk in particular."

It notes however that many firms may have to review their risk questionnaires if that data shows risk tolerance going up and down in sympathy with the markets. Misreadings of risk tolerance may need to be corrected and perhaps previous advice reviewed, the firm warns.

## &gt;&gt; SECTION 05 &lt;&lt;

## Historical Data Modelling: A Must-Have Feature

*"Investment modelling tools which illustrate the impact of various scenarios on a client's portfolio are a very valuable tool in the context of risk-profiling" – Suzanne Spink, UK Head of Global Investment Solutions, Deutsche Bank Private Wealth Management*

One of the most important elements of the risk-profiling and suitability assessment process is ensuring that clients have had investment risks explained properly to them. With this in mind, most practitioners now view historical data modelling capabilities as a must-have feature of risk-profiling systems.

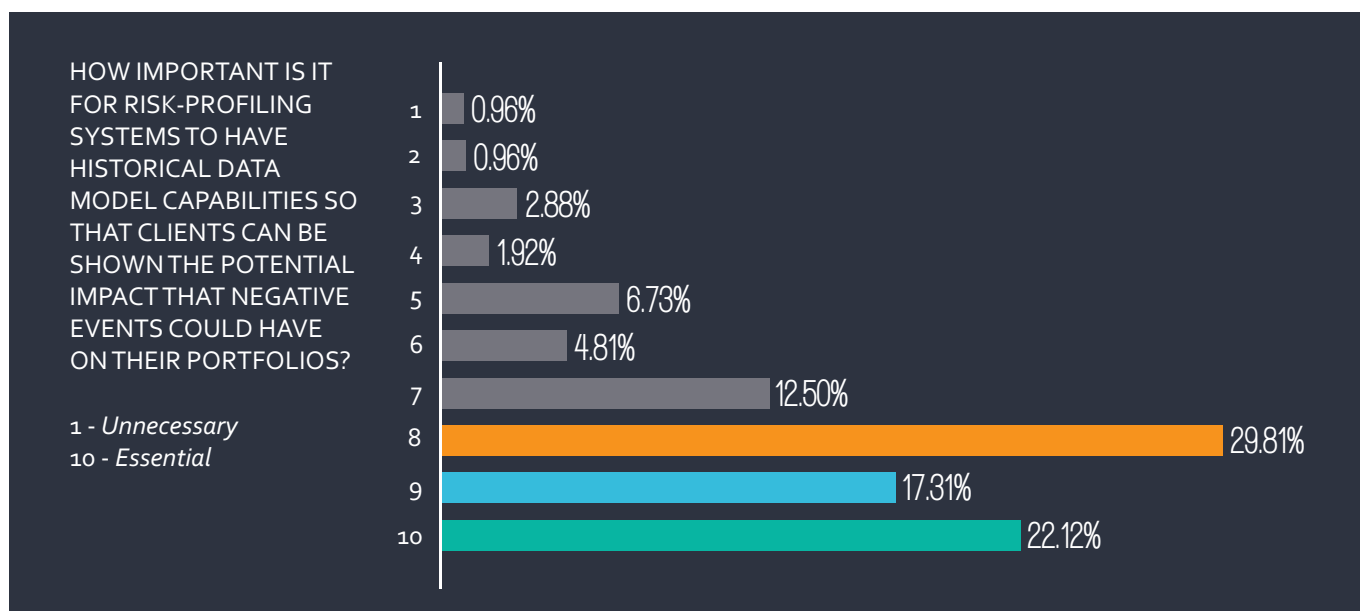
When asked how important it is for risk-profiling systems to have historical data modelling capabilities, an overwhelming 82 per cent of wealth managers surveyed placed its importance at 7 or above on a ten-point scale, with less than 5 per cent saying that these capabilities are unimportant (giving a score of three or less).

how different portfolio structures work under different stress scenarios. The statistical/risk analysis output from this work is also very valuable to investment managers in terms of assessing risk under different risk scenarios," said Martin O'Hare of Signia Wealth.

#### Greater honesty

The facilitation of difficult conversations was another prevalent theme. Being able to illustrate for clients the downside risks on portfolios enables clients and advisors to have "a much more explicit conversation about the trade-offs between risk, return and timeframe," said Ian Woodhouse of PwC.

Having more explicit conversations, which factor in worst-case scenarios, is of course much higher on the agenda since the financial crisis. "The financial crisis has taught us the importance of having real



Being able to clearly illustrate to clients the potential impact that negative events could have on their portfolios was held to be very important by most of the expert panel. Again, helping clients to really understand individual product risk, and the overall risks their portfolio represents was identified as a key priority.

"I think this aspect of risk-profiling is extremely valuable. Although never a guide to future returns, they are very good at showing clients

life 'Black Swan' examples to show to clients. It is vital to make sure that clients truly understand the risks that they are undertaking," said RBC Wealth Management's Tracy Maeter.

#### Fostering engagement

As well as helping clients to really understand the risks they are taking, being able to highlight potential negative events also encourages



them to *honestly* consider their capacity for loss, the experts said.

Highlighting again the emotional element to proceedings, several of the expert panel pointed to how important it is that clients feel comfortable with the level of risk their investments represent and that historical data modelling capabilities have an important role to play in helping clients to really engage with the construction of their portfolio. As Richard Anderson of Lloyds TSB Private Banking explained:

"Clients need to understand the potential risks of an approach and ensure that their comfort with these risks, or otherwise, helps drive the assessment of their risk profile for a particular aim. Clients also need to be aware, and understand, how these risks may be mitigated or increased through a different investment approach."

"In addition, highlighting the potential negative events will encourage consideration of capacity for loss and strategies that the client should take to help reduce these risks to a desirable level of comfort."

This point about helping clients to compare the characteristics of different investment strategies actually came up repeatedly - another instance of how firms should be aiming to act as an educator for the benefit of both clients and their own bottom lines. As discussed elsewhere, many commentators hold that when clients understand more, they buy more.

"The use of back, scenario and stress testing and portfolio risk statistics are particularly useful when illustrating the characteristics of a proposed portfolio through various events. Even more

importantly, they enable a client to compare the characteristics of different approaches," said Daryl Roxburgh of BITA Risk.

"These illustrations should show good and bad times, so that the client gets a clear view of the positive and negative aspects of their portfolio. This can be a great education in the fact that a participative portfolio will participate in the upside and downside in the market, while a defensive one may disappoint in a rising market, but please in a falling one."

### Illustrating upside

The expert panel were in fact keen to emphasise that its not just downside risk which should be clearly illustrated to clients, and that in fact historical data modelling can be useful in helping clients fully appreciate potential upside and the level of risk they need to accept to achieve their aims – something which of course is very important given that many investors are still smarting from losses associated with the crisis and are wary of investing at all.

One further point to note about the use of historical data modelling capacities is that they can be an invaluable way for firms to emphasise the value that their advice is adding, while also increasing their brand cachet as a transparent and trusted partner for clients. One example of using technology in this way came from Graham Bentley of Skandia. "We already have a system (U-Skan) that allows advisors to demonstrate the relative efficacy of historic investment decisions, by showing shadow performance (how you would have performed without the change) versus post-change performance," he said.

## &gt;&gt; SECTION 06 &lt;&lt;

## Full Systems Integration Now “A Must”

*“Integration provides a single point of understanding of all aspects of the client. Attitude to risk is a function of hard and soft facts about a client. It is the sum of many features, and this needs to be held together, recorded together, and updated together”*

– survey respondent

When asked if they thought that it is helpful for risk-profiling tools to be integrated with CRM and portfolio management systems, the respondents to the reader survey were overwhelmingly in favour of such integration. In fact, the majority of respondents (28 per cent) rated this type of integration as a “ten” on a one-ten helpfulness scale, and an overwhelming 90 per cent of those surveyed placed its usefulness at 6 or above.

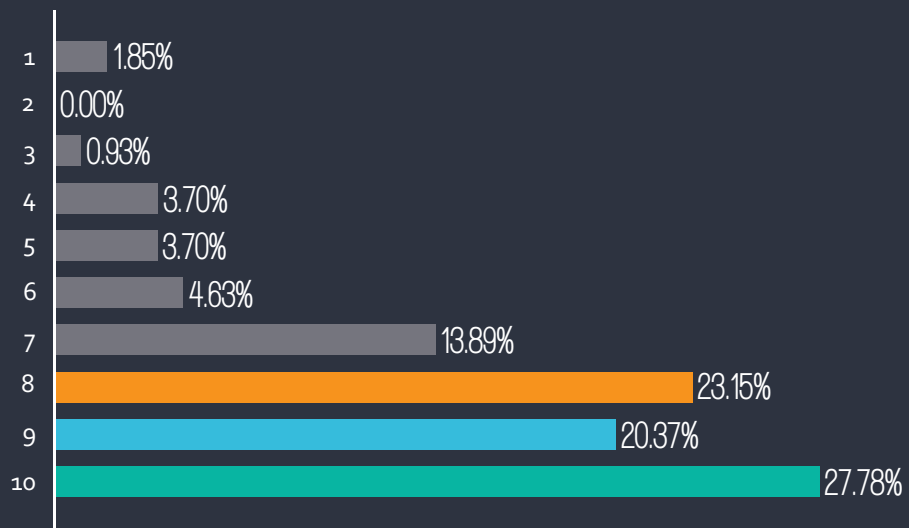
helpful in helping wealth managers to achieve all sorts of goals.

Many respondents to the survey noted that integration is very useful from a compliance perspective if systems automatically highlight mismatches between product and client risk profile (which then require a sign-off to override). The expert panel also said it was very useful if systems are set up to “trigger” advice being offered to clients really promptly when the need arises, and that such integration would be useful in reminding clients of their long-term goals to prevent short-term, knee-jerk reactions.

Ian Woodhouse of PwC, along with several other members of the editorial panel, pointed out that the integration of risk-profiling tools with CRM and portfolio management systems presents “compelling” economic advantages along with making it easier to

DO YOU THINK IT IS HELPFUL FOR RISK-PROFILING IT TOOLS TO INTEGRATE WITH CRM AND PORTFOLIO MANAGEMENT SYSTEMS?

1 - Not helpful at all  
10 - Very helpful



The expert contributors to this report also unanimously agreed that the integration of risk-profiling tools with CRM and portfolio management systems can be very

evidence compliance. The respondents to the reader survey highlighted in particular that such integration would make it easier for advisors to retrieve and update clients' risk-profiles.

## FULL SYSTEMS INTEGRATION: AN ABUNDANCE OF BUSINESS BENEFITS

ADVENT SOFTWARE ANNOUNCED IN DECEMBER 2011 THAT BITA RISK, WHICH PROVIDES PRIVATE CLIENT SUITABILITY ASSESSMENT, RISK-PROFILING AND PROFILE MONITORING APPLICATIONS, HAD JOINED ADVENT'S ALLIANCE PARTNER PROGRAMME. AS A RESULT OF THE AGREEMENT WITH ADVENT, BITA RISK'S BITA STAR AND BITA MONITOR PRODUCTS WILL BE INTEGRATED WITH TWO PRODUCTS THAT MAKE UP ADVENT'S WEALTH MANAGEMENT SOLUTION: ADVENT PORTFOLIO EXCHANGE, ITS PORTFOLIO MANAGEMENT SYSTEM, AND MOXY, ITS TRADE ORDER MANAGEMENT SYSTEM.

HERE, MARTIN ENGDAL, ADVENT'S EMEA DIRECTOR OF BUSINESS DEVELOPMENT AND PRODUCT MARKETING, OUTLINES WHY WEALTH MANAGEMENT FIRMS SHOULD BE LOOKING TOWARDS FULL SYSTEMS INTEGRATION.

For Engdal, wealth managers can realise "huge business benefits" by having a fully integrated platform which spans client on-boarding and risk-profiling to compliance, order management and client relationship management, and then through to back-office accounting, performance monitoring and client reporting.

Firms which have made moves towards such integration have done so off the back of growing regulatory and reputational pressure to demonstrate that they are serving their client's investment objectives with a portfolio that is suitable for their capacity and appetite for risk, he says.

### Beyond compliance

While each of the world's regulators has its own take on the risk issue, it's fair to say that a fully integrated IT platform will enable wealth managers to satisfy even the most stringent of requirements cost-effectively and efficiently, according to Engdal. In fact, in his view firms would do well to consider implementing full integration even if regulators didn't have risk-profiling firmly in their sights.

"Having an efficiently integrated and automated workflow across all aspects of the invest process is crucial to staying competitive," he says.

Engdal notes that one crucial element of the case for integration is that it mitigates the risk of human error by reducing the number of IT systems wealth managers have to access in the course of their daily practice and eliminates having to input information more than once. Happily, this also produces "more satisfied employees as it makes their lives easier", he points out, adding that employees are then able to trust systems output to provide a sound data basis for their clients being comfortable with their portfolios.

### Better systems, better relationships

But the benefits to the client-advisor relationship are the real "selling point" of a fully integrated IT platform, Engdal says. The first

of these benefits is that integration "ensures that all relevant client and portfolio information is at the fingertips of client-facing staff", providing a more holistic view of the relationship with the client. The second benefit is that it embeds a business culture whereby "best of breed" risk-profiling is central to the proposition.

"Systems integration reinforces that clients' risk attitudes are part of the whole client relationship management process and not a separate process which is filed and subsequently not used. This clear understanding builds a firm foundation for the client relationship, helping to manage and meet their expectations," says Engdal.

"If systems are integrated from front to back you continue to monitor and reset as you meet and discuss during client meetings. It ensures that the client's attitude to risk is considered and suitability is taken into account at all stages of the investment process. It helps firms and their advisors to become the 'trusted advisor' as efficient full systems integration makes it easier to demonstrate 'interest/concern' in every step the client takes – reinforcing the value added by the wealth manager."

A more robust process for implementing and reviewing investments is another key business benefit, he points out, since not only does integration automate portfolio construction and rebalancing, it also limits the risk of compliance breaches through early "red flag" warnings.

"Full integration facilitates immediacy of analysis, from pre-trade simulation prevention-type controls to post-trade controls. It also allows for quick identification and communication to clients of unusual investment activity directly," Engdal says.

In short, he believes that the business benefits of systems integration are hard to argue with. "All in all systems integration is key to staying competitive, complying with ongoing regulations, living up to client service expectations – and ultimately profitability," Engdal concludes.

## Differentiation through integration

But over and above achieving time and cost efficiencies, Woodhouse also believes that fully integrated systems can help firms make their offering really stand out from those of their peers.

"There are some exciting developments in this area which can deliver significant advantages, particularly in terms of ongoing advice through value-added alerts for advisors and clients. We believe this will be an increasingly important source of differentiation in the next few years," he said.

Wealth managers seem to broadly agree that interlinking systems which aid client coverage and effectively document communication with clients can make a huge improvement to operational efficiency – however, the expert contributors to this report cautioned that integrating risk-profiling tools with CRM and portfolio management systems should not be viewed as a "magic bullet".

## Avoid over-reliance

Tracy Maeter of RBC Wealth Management noted that integration can "certainly be helpful so that the profiling becomes part of your controls and processes, giving you resources to allow you to know which clients need what kind of attention", but she also cautioned against over-reliance on automation. "Given the personalised nature of the service that we offer to HNW and UHNW clients, we would never wish to rely on automated systems. Frankly, advisors should know what the trigger points are for their clients," she said. The fact that advisors shouldn't rely solely on technology as personal relationships are central to the wealth management proposition was echoed by one survey respondent, who succinctly said: "Systems are only part the solution; they can't get you to a '10'..."

Greg Davies of Barclays also has reservations – but his are more focused on whether the risk-profiling information held by systems is of sufficient quality in the first place. So while he believes integration to be really helpful, he would also add the caveat that it is "only useful if the information is accurate and sufficiently granular."

Davies, who is of course a renowned expert in the field of behavioural finance, points out that even if measured correctly, risk tolerance doesn't provide an accurate measure of a client's "nerviness", which is "a quite distinct psychological trait which needs to be measured independently and accurately." In his view, long-term willingness to take risk needs to be measured separately from short-term nerviness and attitudes towards liquidity. If risk-profiling information isn't as "high resolution" as this then what you are left with is a "blunt tool" which should not really be relied upon for client relationship management or portfolio management, he says.

In addition to cautioning against over-reliance on automation and ensuring that the original client data is "high-res" enough, Daryl Roxburgh of BITA Risk also brought up a salient point concerning regulatory risk – namely, Treating Customers Fairly rules. He gave the hypothetical example of a fully integrated risk-profiling system prompting an advisor to call a "nervy" client when a particular stock they are holding falls significantly. In this scenario "there is the risk of a client complaint if a client not considered 'nervier' did not receive a call regarding the falling stock when the 'nervier' client did," he warned. As such, he advises that TCF must be considered carefully in any ap-

plication of segmentation of action by client profile. That said, if such considerations are dealt with he sees integration as very positive from a TCF standpoint.

"If integration led to all advisory clients who did not hold a recommended investment for whom it is suitable receiving a recommendation to buy it (in the context of their portfolio), the tracking of their response and included detailed reasons why other clients did not receive the recommendation, it could add significant value to the firm while ensuring regulation compliancy and enhancing the service to the client," he said.

## The possible benefits of full integration: what the survey respondents said:

Since 90 per cent of the survey respondents saw the integration of risk-profiling tools into other systems as really useful, they had a lot to say about the potential benefits this represents. The potential benefits identified included:

- Reducing the number of systems which staff have to access in the course of their daily practice, along with the obviation of human error from having to input information more than once
- Easier updating of information and flagging of portfolio "drift"
- Better portfolio construction with better "red flags"
- A more holistic view of the relationship with the client
- Less variance in the risk assessment of clients
- Much more effective marketing (and therefore more take-up of investment proposals)

## What the survey respondents also said:

- "Such integration prompts input and so is invaluable in ensuring that specific records are kept and monitored."
- "Integrated systems can be really useful in reminding clients themselves of their agreed risk profile if they want to get into riskier complex/higher-risk products."
- "Integration reinforces that clients' risk attitudes are part of the whole relationship management process, not a separate piece of information to be gathered at the outset and not used. If systems are integrated you continue to monitor and reset as you meet and discuss with the client, and ensure when trading and reporting that the client's attitude to risk is considered, and suitability is taken into account at all stages of the process."
- "Full integration facilitates immediacy of analysis, from pre-trade simulation prevention-type controls to post-trade detective type controls. It also allows quicker identification and communication to clients of unusual investment activity, indicating for example a change in risk appetite or potentially a possible fraud (be it internal or external) on the account. Furthermore, integration makes it easier to demonstrate 'interest/concern' in every step the client takes – reinforcing the value added by the wealth manager."

## INTEGRATION SHOULD BE "A GIVEN"

JOSS MITCHELL, DIRECTOR OF UK BUSINESS AT CITI PRIVATE BANK, DISCUSSES HOW RISK-PROFILING STANDS IN THE INDUSTRY TODAY

For Joss Mitchell, the integration of risk-profiling tools with client relationship management and portfolio management systems should be "a given" today. "To be honest, I now see the systems all as one," he says. "I don't see how you can be an effective portfolio manager without having the risk-profiling systems integrated into the back of the system as well. More integration makes it easier for the managers, for the bankers, and so surely it's got to make things better for clients."

### Record-keeping

According to Mitchell, part of the reason that the industry has some way to go in improving its record-keeping is that historically it's come from a "largely self-regulated background" and it used to be down to the individual manager and the firm to maintain records. However, as regulations have become stronger over the past twenty years demand has increased for record-keeping as it has now been a legal and regulatory requirement for a number of years. "Some firms have been quicker than others (because at the end of the day this all costs money), but I think we've largely arrived at an industry standard on how long to keep data etc," he said.

While Mitchell agrees that record-keeping can be improved, he believes the industry should keep an eye on relevance. "The problem is rubbish data in, rubbish data out. The data you retain has to be relevant," he said. "The danger is we go into an environment where we just 'kitchen sink it' and records are kept which are full of everything - which doesn't actually help. In fact, what it actually does is bog everything down. Yes, we need to retain information which helps us manage our client relationships long-term, but we need to make sure it's the relevant information."

### What represents best practice?

Like most practitioners, Mitchell views risk-profiling questionnaires as just a small part of the puzzle and believes it is the in-depth fact-finding and ongoing discussions with clients which are key. Quantitative methods "shouldn't be relied upon", he said, echoing comments made by most of the contributors to this report. The problem is that questionnaires can be "one-dimensional" and fail to pick up the all-important subtleties which a conversation with a skilled advisor will uncover, he says, noting that "the problem with any pre-formatted template is that it is exactly that: pre-formatted."

Aside from the fact that risk-profiling questionnaires often fail to pick up all the complexities of clients' situations, he is also concerned that some profiling processes don't take enough account of the fact that clients' risk profiles can and do change radically over time. "A client's risk profile from two years ago is potentially very different to their risk profile today," he notes. "Invariably what has happened in the industry in the past is that a client would be asked to complete a questionnaire at client take-on, then in theory there should be an ongoing discussion over time... but I wonder the extent to which that has actually happened across the industry."

In Mitchell's view, the key to best practice when it comes to risk-profiling is a mixed methodology. "It's a combination of everything. To have a template is important, but it should not be relied on. There has to be a bringing together of a template, an ongoing risk diagnosis which is scientifically looking at data all the time and also day-to-day holistic conversations with clients," he says. Bringing all of this data together is a difficult but essential part of client relationship management in Mitchell's view.

## &gt;&gt; SECTION 07 &lt;&lt;

## Mitigating Business Risk

*"Effective suitability assessment is a prerequisite of financial advice, not a commercial insurance policy" – Graham Bentley, head of proposition at Skandia*

The respondents to the reader survey overwhelmingly agreed that effective and accurate risk-profiling and client suitability assessment has a very important role to play in mitigating business risk, with 74 per cent of those surveyed placing its importance at seven or above on a ten-point scale. The expert panel were in agreement, saying that accurate risk-profiling and client suitability assessment is a key factor in reducing business risk in relation to client complaints and suitability/mis-selling issues. However, as they noted, the risks of inadequate processes are potentially even more wide-reaching.

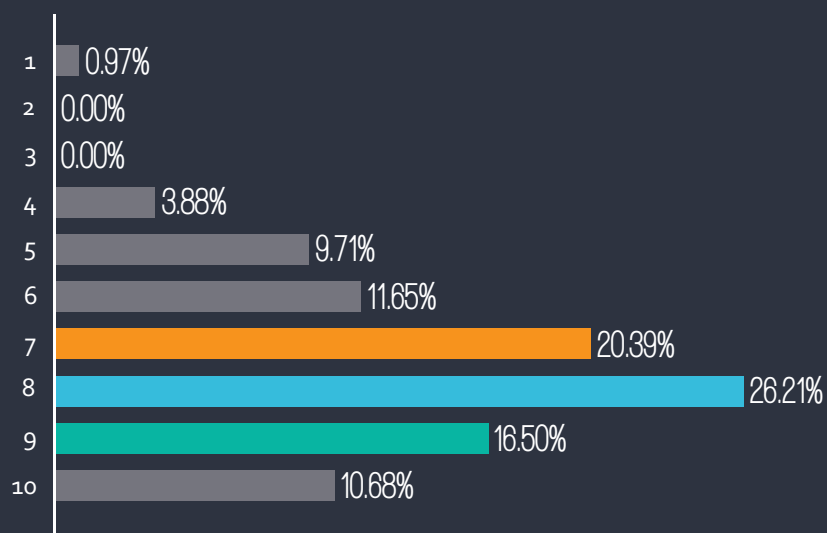
## Protecting against reputational damage

Of course, the business risk of having inadequate risk-profiling and client suitability assessment processes in place goes beyond the spectre of regulatory censure and financial penalties – a lot of the issue concerns the reputational damage which comes along with disappointed clients.

As Benjamin Manz of Assetinum pointed out, if clients are more aware of the risks involved in their investments in the first instance then "their expectations tend to be more realistic." "In cases of bad performance the reaction of well-informed clients tends to be more balanced," he said.

HOW FAR DOES  
EFFECTIVE AND  
ACCURATE  
RISK-PROFILING AND  
CLIENT SUITABILITY  
ASSESSMENT  
MITIGATE BUSINESS  
RISK IN YOUR VIEW?

1 - Not at all  
10 - Very significant



Inadequate risk-profiling and client suitability assessment processes clearly carry significant business risks. The financial costs of non-compliance can of course be high; if it is found that a firm's processes are flawed to the extent that systemic issues exist then regulators can then enforce a costly past business review to identify cases where unsuitable advice was given and – where client detriment exists – redress will have to be paid.

Greg Davies of Barclays also picked up the point that risk-profiling is about managing clients' expectations. "Investing is risky, and if the portfolios given to clients are not suitable for them in a transparent and intelligible way then there is always a risk of misaligned expectations and thus client dissatisfaction with inevitable periods of temporary poor performance along the way," he noted.

Summing up the issues, Tracy Maeter of RBC Wealth Management said: "Accurate and effective risk-profiling is absolutely integral to mitigating business risk. Quite apart from the dangers of mis-selling, where we don't really understand our clients' risk profile we are unlikely to meet their expectations or *keep* these relationships. So, in addition to the 'hard' costs of not getting it right, there are important relationship and reputational issues to contend with as well."

#### The human element

Several members of the expert panel in fact pointed to the positive effect which enhanced risk-profiling and suitability assessments can have on an advisor/firm's relationship with clients. There needs to be a recognition that there is a *person* at the end of every process, it was said. Managing wealth is essentially about managing fears and dreams and so there needs to be an appreciation that there is an emotive element to risk-profiling.

As Barclays' Davies pointed out, as humans we all respond emotionally to the investment journey and so it's important for clients

to be emotionally comfortable with their portfolios. If this is not the case, then clients are likely to make "emotionally driven and costly changes," he warned. It's also important to note that such ill-founded, "knee-jerk" decisions are also likely to negatively impact long-term portfolio performance, thereby compounding client dissatisfaction.

Several other panel members agreed that in-depth, accurate risk-profiling and suitability assessments are fundamentally about how the client *feels* about their portfolio and if they are reassured. "The first and only important element is the guidance and comfort it gives the customer," said Graham Bentley of Skandia.

Again, the issue seems to boil down to advisors and clients coming to a common understanding and communicating well – and that means with honesty and openness. In fact, as will be discussed, beyond being just being a box-ticking exercise to satisfy the regulators, enhanced risk-profiling can be invaluable in making clients feel more empowered and that they are *partnering* with a trusted institution – with obvious advantages when it comes to retaining their business.

## &gt;&gt; SECTION 08 &lt;&lt;

## Encouraging A Deeper And More Open Relationship With Clients

*"Risk-profiling is one of the first things that happens when a client walks in the door and it is a great opportunity to set the right tone"*  
– Tracy Maeter, head of investments for the British Isles at RBC Wealth Management

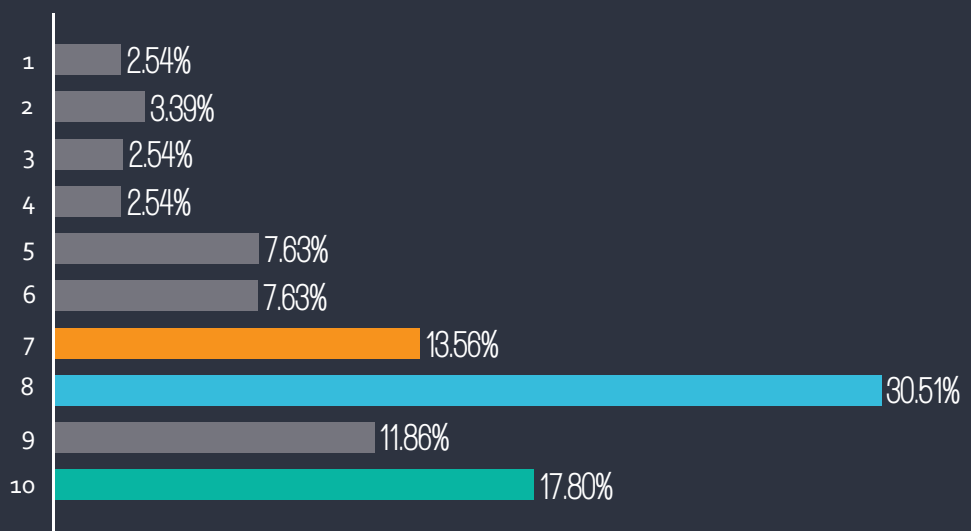
Implementing enhanced risk-profiling systems is not just a matter of satisfying regulatory requirements, mitigating business risk and improving operational efficiency, and while there are many "concrete" benefits to making such enhancements, better client risk-profiling can also have real benefits to the client-advisor relationship. When asked if they thought that enhanced risk-profiling encourages a deeper and more open relationship clients, the respondents to the reader survey overwhelmingly agreed that this was the case. Almost three quarters (74 per cent) of respondents placed the impact enhanced risk-profiling has on encouraging deeper and more open relationships with advisors at 7 or above (on a 10 point scale).

That enhanced risk-profiling sets the "right tone" for the relationship was in fact highlighted by several panel members. For Suzanne Spink of Deutsche Bank Private Wealth Management, encouraging a deeper, more open relationship starts with "clearly articulating the need for risk-profiling and why it is important in the context of the clients' objectives, circumstances and attitudes." As mentioned elsewhere in this report, from a branding and marketing perspective this "educative" element is obviously extremely important as is the fact that it addresses clients' increased desire for transparency and also fosters trust.

Daryl Roxburgh of BITA Risk made the point that enhanced risk-profiling is important in managing clients' expectations – something which is very important in terms of preventing mis-selling-related complaints, not to mention reputational management. "When implemented properly it [risk-profiling] will encourage a discussion that centres on both the positive and

IN YOUR VIEW,  
DOES ENHANCED  
RISK-PROFILING  
ENCOURAGE A  
DEEPER AND MORE  
OPEN RELATIONSHIP  
WITH CLIENTS?

1 - Not at all  
10 - Very much



Broadly speaking, the expert editorial panel were in agreement that enhanced risk-profiling procedures do facilitate a deeper and more open client-advisor relationship. In fact, having really robust and detailed risk-profiling procedures in place is essential in getting wealth management relationships off on the right footing, as Tracy Maeter of RBC Wealth Management pointed out. "Risk-profiling is one of the first things that happens when a client walks in the door and it is a great opportunity to set the right tone," she said.

negative aspects of investing in risky assets and helps to set and manage client expectations," he said.

Roxburgh added that the openness which is fostered by enhanced risk-profiling procedures "should encourage both parties to discuss issues that arise during the investment process as well as giving a frame of reference for that discussion". This point about creating a true dialogue came up repeatedly.



Richard Anderson of Lloyds TSB Private Banking, summarised the issue in these words: "Enhanced risk-profiling enables more in-depth conversations with clients, enables advisors to better understand a client's personal drivers for investing and provides clients with a greater understanding of investment risk and the rationale for recommendations. Overall, enhanced risk-profiling is a two-way communication process that draws a client into financial planning and helps the advisor and client work together to help reach appropriate outcomes."

For Greg Davies of Barclays, the risk-profiling process is also about forcing advisors to be objective and to really focus on what the client needs, as opposed to the investment the advisor would like to put them into, and preventing a "blind eye" being turned to some elements of the picture.

For him, enhanced risk-profiling forces "transparency and objectivity about important dimensions of who the client is, and what their needs are" while encouraging "deeper discussions that might otherwise be avoided in the desire to secure the deal."

"It forces on bankers a sense of objectivity such that clients get portfolios genuinely suited to their needs, rather than just a variant of the portfolio that the banker prefers," he says.

And it's not just about forcing advisors to examine their views; Davies also believes that really robust risk-profiling "provides an opportunity to challenge clients' stated opinions and desires where these might not be the most suitable investment approach over the cycle."

It is also worth noting that the deeper dialogue which is fostered by enhanced risk-profiling can also help institutions to win more business, said Ian Woodhouse of PwC. As he points out, having better quality conversations with clients around risk and return performance could allow firms to illustrate that in some instances they are offering a better return for the same risk profile than their competitors.

Anderson also made the point that by recording a client's willingness to accept risk over time an advisor is able to understand more clearly how changes in personal circumstances affect the recommendations provided previously and going forward. This emphasis on the risk conversation needing to be an *ongoing* dialogue was picked up on repeatedly by the expert panel in recognition that clients' unique situations are as much in flux as the markets are.

#### How often should risk-profile be revisited?

There is some debate as to how often clients risk-profiles should be revisited, but most contributors seemed to agree with RBC Wealth Management's Maeter, who believes that "risk-profiling should be part of advisors' regular conversations with clients, and should certainly be revisited formally at least on an annual basis, or as clients' circumstances change."

While revisiting clients' risk profiles at regular intervals and when a major life event has occurred is widely held to be best practice, some industry figures believe however that the industry should be moving towards something far more dynamic (for more on this issue see the interview with Scorpio Partnership's Seb Dovey on page 36).

## SURVEY REVEALS WORRYING LACK OF RISK AWARENESS AMONG INVESTORS

Despite warnings from the UK regulator that investment firms should be tightening up their suitability processes, recent research by Skandia Investment Group uncovered a worrying lack of awareness over risk among investors.

Having surveyed 2,000 people who have an investment product, the firm found that half are only "vaguely aware" of the level of risk that it entails. Even more worryingly, a further 8 per cent of those surveyed said they had absolutely no understanding of the level of risk they were taking on at all. Just 40 per cent of respondents said they understood in detail the level of risk they were taking on.

Significantly, the firm found that for 60 per cent of people the amount of money they might lose, rather than what they might gain, is a more important consideration when considering an investment.

Perhaps predictably in light of the losses many have endured over recent years, the survey revealed that most UK investors today have a relatively low tolerance for risk. Over two thirds (69 per cent) put their own risk level at five or less out of ten, while only 5 per cent of investors put themselves in the highest risk category of eight plus.

However, when risk was put in starker terms and investors were asked to assess the maximum potential investment loss they would

be prepared to accept in relation to a potential gain, investors were even more risk averse. On this basis 79 per cent of those surveyed fell into a risk level of 5 or less. According to Skandia's risk-profiling methodology this meant they are prepared to accept a maximum potential loss of 14.91 per cent for a potential gain of 27.37 per cent.

The findings underline how much disparity there can be between the risk tolerance which a client might self-report and their actual tolerance, when expressed in terms of a trade-off between potential losses and gains. It has been noted that as clients naturally tend to focus on their return objectives, this classically leads to a discrepancy between the returns that they are seeking and the risk that they're willing to take on. Many firms have recently noted that clients have become so risk-averse in some cases that they are unwilling to take on the level of risk necessary for their planning goals - like retirement - to be achieved within their preferred timescales.

Skandia - like several other firms - has tried to plug this knowledge gap by launching a range of risk-rated funds intended to make it easier for advisors to explain potential outcomes to their clients. Typically, such funds are managed to deliver maximum returns for an agreed level of volatility so that investors are less at the mercy of market gyrations when they decide to buy or sell their holdings.

## &gt;&gt; SECTION 09 &lt;&lt;

# Empowering Clients Through Enhanced Risk-Profiling

*"Enhanced risk profiling procedures are about matching needs and expectation to outcomes...they are therefore vital"*

– Graham Bentley, head of proposition at Skandia.

It could be easy to get into a negative mindset about the never-ending changes being implemented by the world's regulators, especially since cost-income ratios are now at an average of 80 per cent (according to Scorpio Partnership). But it is important to take the positive out of the changes being wrought, industry experts say.

One area where the (forced) enhancements being made to risk-profiling procedures are seen in a positive light is in empowering clients to make better financial decisions.

When asked to what extent enhanced risk-profiling procedures can empower clients to make better decisions when it comes to their wealth management, 75 per cent of respondents to the reader survey said its impact was significant (rating it 7 or above on a 10-point scale). Conversely, very few of those surveyed thought that enhanced client risk-profiling procedures would have an insignificant impact on empowering clients (less than 5 per cent rated it at 3 or less on a ten-point scale).

procedures from mere box-ticking exercises to a key way of increasing client satisfaction while also satisfying regulatory obligations more thoroughly than ever before.

Other things being equal, enhanced risk-profiling does empower clients, said Signia Wealth's Martin O'Hare. "A greater understanding of risks is critical when it comes to making decisions on all investment products, and to achieve longer-term objectives relating to wealth management/wealth preservation," he said.

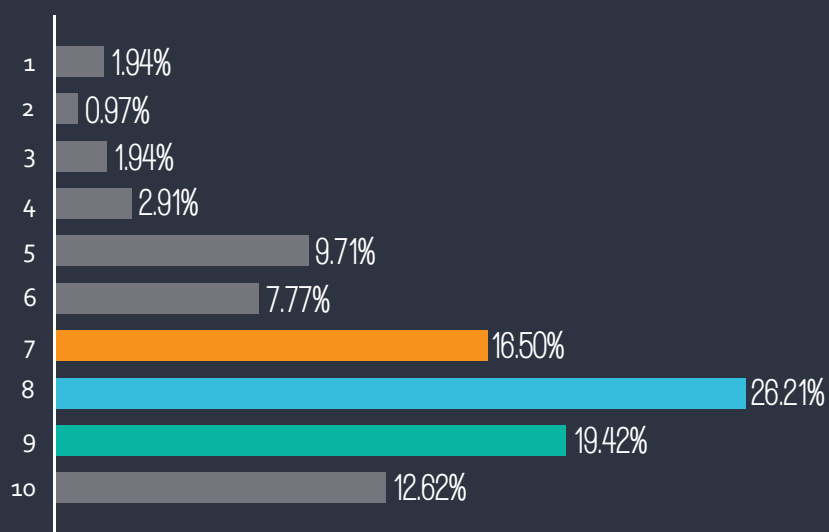
Graham Bentley of Skandia sees enhanced risk-profiling procedures as "vital" as they are "about matching needs and expectation to outcomes." This was a theme also picked up on by Ian Woodhouse of PwC. For him, the issue comes down to clients being enabled to make "more informed trade-offs between their performance and risk within and across their wealth".

"Enhanced risk profiling procedures help clients to better understand their goals versus their risk for individual elements of their wealth as well as for their overall aggregated wealth," he continued.

For Suzanne Spink of Deutsche Bank Private Wealth Management,

TO WHAT EXTENT  
CAN ENHANCED  
RISK-PROFILING  
PROCEDURES  
EMPOWER CLIENTS  
TO MAKE BETTER  
DECISIONS WHEN IT  
COMES TO THEIR  
WEALTH  
MANAGEMENT?

1 - Not at all  
10 - Very significant



## Increasing client satisfaction

These sentiments closely matched those of the expert panel, who agreed that enhanced risk-profiling procedures can move risk-profiling

enhanced risk-profiling procedures help clients to make much better-informed decisions since they encourage them to actively consider their investment objectives and to make their investment decisions in light of these broader goals.

## Education, education, education

It would seem that those in the industry also believe that enhanced risk-profiling processes can form an important part of efforts to better educate clients. In fact, it seems to be increasingly the case that firms are seeing themselves as educators and are positioning themselves as thought-leaders (this trend was discussed in *WealthBriefing's* recent research report, *Reaching Out To The High Net Worth: Branding and Marketing Strategy Across The Global Wealth Management Industry*).

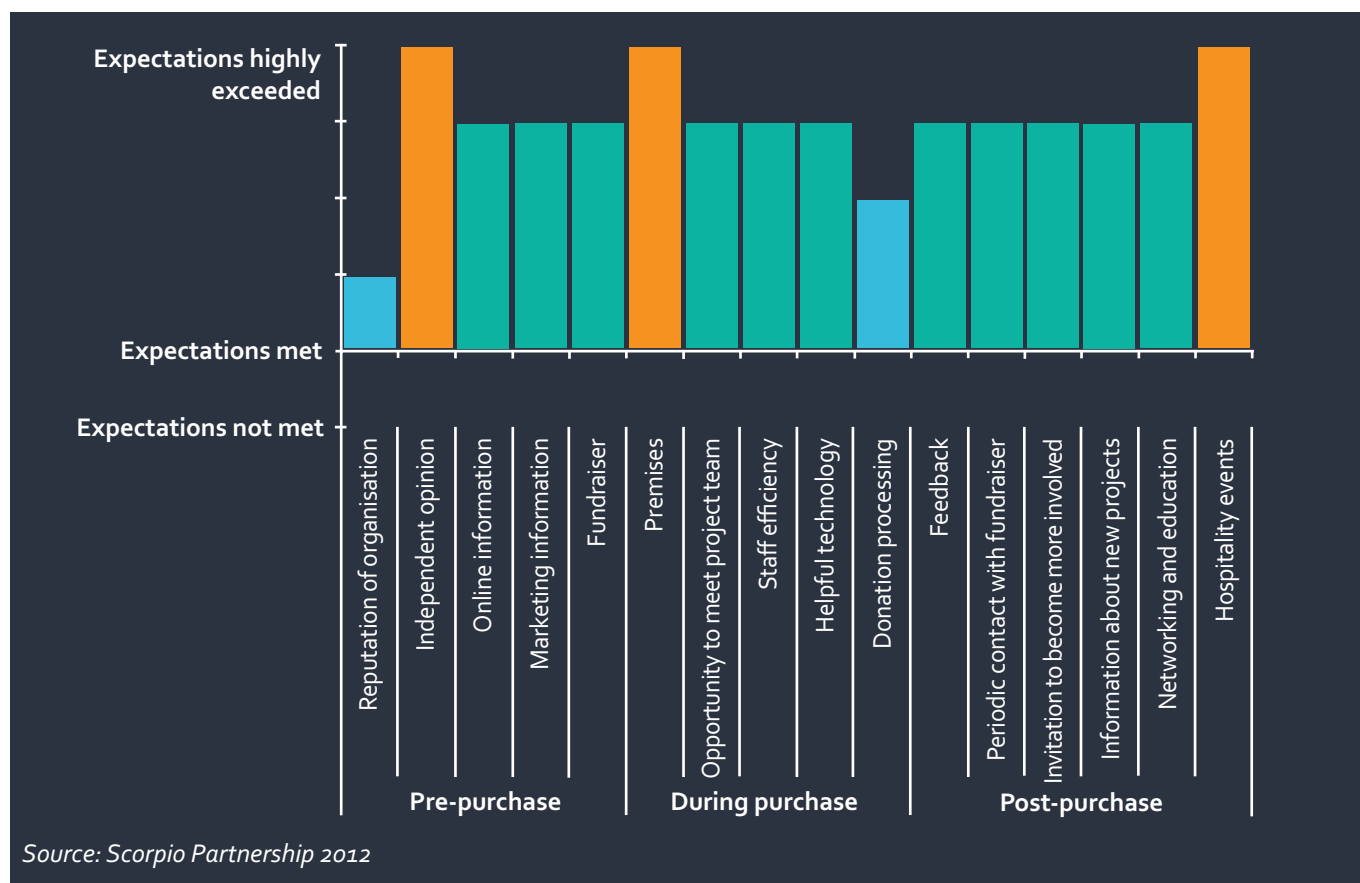
It should also be noted that the latest Scorpio *Futurewealth* Report found that clients felt that education was one “post-sale” area where wealth managers could really do more to exceed their expectations (see figure below). Clients clearly want to feel that their wealth managers are concerned that they are empowered and supplied with as much education as they have need of.

Apart from building up brand equity as a trusted and transparent partner, helping clients to understand their own feelings about risk and how this affects their investment behaviour is clearly good for both the institution and the client.

## Shaping investment behaviour

But the issues aren't just about how clients *feel*, but also how they act as an investor. Here, the educative benefits of enhanced risk-profiling processes can have a double benefit.

Firstly, as previously touched upon, enhanced risk-profiling processes can help investors to avoid the “knee-jerk” investment decisions which are the result of clients not properly understanding their own attitudes and the risks investments carry. As discussed on page 21, many firms are now looking – through behavioural finance – to construct portfolios which are designed to anticipate emotional reactions to market turmoil.



It hardly needs to be said that if they feel better informed about investment risk clients will more inclined to trust their wealth manager (the battering which trust levels took during the financial crisis is well documented; trust in financial services firms still recovering, various studies say).

“The ability to educate the client through this process helps investors to fully understand the levels of risk and their appetite for risk, and will lead to confidence in the appropriateness of the investment and indeed confidence in the integrity of the advising firm,” said Daryl Roxburgh of BITA Risk.

“It [enhanced risk-profiling] can help a lot. It is clearly better that clients understand their own attitudes to risk and how it may change in different circumstances. When this is combined with understanding the risk of their portfolios, their decision-making naturally improves,” said Gary Tiernan of Standard Chartered Private Bank.

The second benefit of making clients feel more empowered and informed is that this will arguably lead to a willingness to do more business with an institution.

According to Seb Dovey managing partner of Scorpio Partnership, clients are currently thirsting for education and giving them this is a key way to garner wallet-share. "You have to ask the client what they want and what would make them do more business. Clients want more knowledge and reassurance – then they'll buy more," he said, adding that clients are actually crying out for more education on the whole spectrum of wealth management services and products.

However as firms look to improve their clients' knowledge and confidence they should also focus on really communicating with clients and speaking to them in a clearly understandable way. As BITA Risk's

Roxburgh points out, "volatility, VaR (Value at Risk) psychometric tests and risk statistics are very often jargon to clients."

In his view, the biggest risk to firms and their clients is "missed expectations."

"Therefore a clear, understandable, transparent risk-profiling process that displays risk in a way that they can understand and therefore helps both them and their manager agree and define their expectations, truly aids their ability to make informed decisions and choices," Roxburgh said.

## SCORPIO'S SEB DOVEY LOOKS TOWARDS A RISK-PROFILING REVOLUTION

*SEB DOVEY, MANAGING PARTNER OF SCORPIO PARTNERSHIP, GIVES HIS VIEWS ON WHERE THE INDUSTRY SHOULD BE HEADING IN TERMS OF ITS APPROACH*

For Seb Dovey, the wealth management industry needs nothing less than a wholesale revolution in its attitude towards risk-profiling – one which shifts the onus onto clients' life plans rather than avoiding regulatory censure.

While Dovey doesn't blame the industry for having developed what is arguably a "box-ticking" mentality which focuses on satisfying compliance obligations, he believes that few wealth managers are taking enough account of clients' life needs when carrying out risk-profiling.

Although there is a lot to be said for new risk-profiling methodologies which deploy behavioural finance theory, in his view this approach is too scientific and in effect measures the wrong things. Instead of exploring just clients' financial risk profile (in essence their betting traits) firms should be looking at their *life* risk profile, Dovey says.

By this he means that firms need to take into account a whole range of factors such as where clients are in their careers/where their businesses stand and what their marital/family situation is – in short, the industry needs to make risk-profiling "more subtle".

As Dovey notes, it is not that advisors haven't been taking these factors into account when making their recommendations, it is simply that institutions have been relying far too heavily on the knowledge advisors build up over the years. But more thorough and subtle risk-profiling is about more than mitigating "key man" and compliance risks, it's also about empowering clients and putting risk-profiling firmly back in their hands, he argues.

### "Real time" risk-profiling

The contributors to this report broadly said that ideally clients' risk profiles should be revisited at least annually as well as after major life events, but Dovey's view is that the industry should be aiming far higher to keep information "live". "Arguably, risk-profiling should be carried out every day," he says, adding that we're not far away from a world where we can cope with that amount of data.

While Dovey recognises that firms have to schedule in risk profile review timeframes for practical management reasons, it is his belief that "to some extent putting a linear time on it is artificial."

"In an ideal world, risk-profiling should be real time," he says.

In Dovey's view, risk-profiling should evolve to the point where it is not the institution which is asking for the information but rather the client who is *offering* it. "Risk-profiling information actually needs to be proactively supplied by the client...we need clients to be proactively updating their risk-profile and telling us where they are," he says.

### "You may also like"

Dovey believes that wealth management firms have a lot to learn from other sectors and social media when it comes to eliciting and using information from clients. In fact, some aspects of services like Amazon and Facebook could almost directly translate into wealth management, in his view. In the future we could see investment propositions being offered to clients on the basis of "you may also like", much in the way that Amazon recommends books. We could even see something along the lines of "clients like you also invested in..." he says.

Dovey's eyes may be firmly on the future, but he holds that the business case for this approach to risk-profiling is compelling. Not only would such "recommendations" boost sales, but there is also a possibility that regulators will also come to accept that this approach does not actually constitute investment advice and so additional compliance concerns are not necessarily an issue.

As it turns risk-profiling "on its head", Dovey also believes that the industry needs to put much more emphasis on the emotional side of wealth management. "It's typically thought of as being 90 per cent mathematics and 10 per cent emotions, but actually the split is the other way round," he says, adding that wealth management is in essence an emotive issue.

Dovey firmly believes that the industry needs to undergo a cultural shift which recognises that risk-profiling data "is top-drawer, not bottom-drawer information" and that the risk conversation should be an ongoing dialogue not a one-off box-ticking exercise.

"Risk-profiling is a fundamental gateway for the institution and advisor to start the relationship with clients, but we need to recognise that it not a static piece of information," he concludes.