The True Potential Centre for the Public Understanding of Finance

The Open University Business School

# Green Paper: Towards a Common Understanding of Risk

## OVERVIEW

**When it comes to saving and investing the average UK consumer is generally unwilling to take risks with their money. But they also have a poor understanding of the nature of financial risks.**

At a time when the idea of 'self-service' saving and investing is gaining ground and people have new freedoms (for example how they can use their private pension saving and how much they can save and invest tax-free), we need fresh thinking about how to encourage the average person to consider the financial risks they face in their lives, how to help them think about and describe their own attitude to risk, and how they can use this knowledge when they save and invest.

This Green Paper is a discussion paper, that aims to set out some of the key issues that we should be concerned about when it comes to people's understanding of financial risk and how attitude to risk is measured and understood.

It also sets out our agenda for exciting new research that focuses on four key questions:

1. What do people understand by the term 'risk' in relation to saving and investing and what informs this understanding?
2. To what extent do existing risk profile tools reflect people's own understanding of risk?
3. Is there scope to improve risk profiling to provide a better indicator of people's attitude to risk?
4. Is it possible to develop a tool that consumers could use themselves? What would this look like?

To answer these questions, we plan to conduct in-depth interviews with policymakers, consumer organisations, and the general public over autumn 2014. The insights from the research will be presented at a Round Table event, designed to take forward fresh thinking into policy and practice.

## When it comes to saving and investing, the average UK consumer is generally unwilling to take risks with their money…

Consumer research consistently shows that people are financially 'risk averse'. In other words, they don't want to buy investments if there is any risk they may lose some of the original sum they invested, even if there is an opportunity for higher returns than, for example, putting the money in an ordinary savings account.

## … but at the same time, they have a poor understanding of the nature of financial risks

68% of people agree 'It is better to play safe with your savings, even if investing in higher risk investments could make you more money.' 18% disagree. Attitudes to pensions: The 2009 survey. DWP Research Report 701.

There is evidence that, beyond a basic understanding of the risk-reward relationship and the idea of capital risk (the possibility that investors may lose some or all of their original capital and re-invested returns), the average consumer has a limited grasp about the financial risks actually involved in saving and investing.[1]

In a low interest rate environment, for example, inflation risk should be a major concern for ordinary savers. This is the risk that the return on savings (after any tax has been paid) falls in real terms due to price inflation.

There is also shortfall risk: in plain English, the risk that you do not meet your savings or investment goals. For example, for someone with an investment plan to pay off an interest-only mortgage, there is the risk that the investment does not generate the principal sum of the mortgage by the repayment date.

As a nation of homeowners, in the UK many people feel that investing in property is 'as safe as houses', without taking liquidity risk into account: the risk that you cannot cash in your investment (such as your home) quickly enough or at an acceptable price when you want or need the money.

And, as an ageing population, nowadays we are more exposed to longevity risk than in the past: the risk that you might outlive your retirement resources. According to the Office for National Statistics, life expectancy for UK men at age 65 increased from 17.5 years in 2006-08 to 18.2 years in 2010-12 (i.e. a 65 year old man is expected to live to age 83). For women, the increase was from 20.2 years to 20.9 years (i.e. a 65 year old woman is expected to live to age 85).

[1]See, for example, *Consumer Understanding of Financial Risk, FSA Consumer Research Report 33, 2004; and Investment risk rating: Consumer attitudes towards risk, Financial Services Consumer Panel, 2007*.

52% of people would prefer to miss their savings goals than take investment risk, while only 12% would not. How do savers think about and respond to risk? Pensions Institute, Cass Business School, 2014

## The risk of 'reckless conservatism'?

While taking little or no financial risks with their money may be absolutely the right thing for some consumers, academics and industry commentators point to the risk of 'reckless conservatism' – the reluctance of many people to take investment risk which in turn may jeopardise their longer-term objectives (such as providing an income in retirement).[2]

As the balance of responsibility shifts away from the state and towards individuals to fund major costs such as retirement and care in old age, this question about the risk of 'reckless conservatism' becomes more pressing. It forms an important part of a wider debate about how to ensure that the financial services industry delivers good outcomes for individuals, but it has received comparatively little attention outside the specialist financial press. Industry representatives have, for example, warned about the dangers of the widely-held public belief that 'cash is king' in relation to the proposed pension liberalisation from 2015[3] and New Individual Savings Accounts.[4]

Consumer survey data shows that the proportion of British households with ordinary savings accounts fell 10 percentage points (from 68% to 58% of households) between 2008/10 and 2010/12 – but so did most other forms of financial asset-holding.[5] This suggests that, in a low-interest rate environment, households are not switching from cash savings to investments in an effort to obtain better returns. There are many reasons why this might be the case, including a preference or need for short-term liquidity over longer-term returns. But it may also be indicative of 'reckless conservatism'.

Risk profiling tools are mainly used as part of an advisory process that typically has the following steps:

- An initial fact find and discussion of risk and return
- Completion of the risk profiling tool
- An assessment of the customer's ability to cope with investment loss
- Discussion with the customer
- Suitability recommendation

## So how do financial firms assess people's attitude to risk?

Assessing a clients' attitude to risk is a crucial aspect of the advice process. Get it right, and the client has an investment product that matches their appetite for risk and is appropriate to achieve their investment goals. Get it wrong, and the client has an investment product that exposes them to too little or too much financial risk compared to their attitude to risk - even if it might achieve their desired investment goals. At worst, getting it wrong could result in a case of mis-selling.

The standard way used by financial firms to assess attitude to risk (and investment risk in particular) is a risk profiling tool, which is mainly used as part of an advisory process. There are a range of risk profiling tools on the market that financial advice firms typically pay a license to use.

[2] *How do savers think about and respond to risk? Evidence from a population survey and lessons for the investment industry.* Pensions Institute, Cass Business School, 2014
[3] 'Cash is king' will kill pension pots: Just Retirement', FT Adviser, 07/07/14
[4] 'True Potential warns savings will reduce in value if savers use their Nisa allowance to invest in cash alone', FT Adviser, 30/06/14
[5] *Wealth in Great Britain Wave 3, 2010-2012. Chapter 5: Financial Wealth*, ONS, 2014

Risk profiling tools comprise a questionnaire that is administered to the client using pen-and-paper or online. Behind the scenes, algorithms are used to score the client's answers to the questionnaire and to provide a risk profile for the client that can be used to help select an appropriate saving or investment product or products. For example, Morningstar's five risk profiles are Defensive, Cautious, Balanced, Growth, and Aggressive. The ATR Questionnaire produces five similarly-labelled risk profiles: Cautious, Moderately Cautious, Balanced, Moderately Adventurous, Adventurous. Data provided by True Potential LLP, which uses the Morningstar risk profiles, shows that at any one point in time, the great majority of clients invest in Defensive (6% of clients), Cautious (27%) or Balanced (53%) funds. Only a small proportion of clients invest in Growth (11%) or Aggressive (3%) funds.

Risk profiling tools also perform a regulatory compliance function: they help demonstrate to the regulator that an adviser has considered the client's attitude to risk in an appropriate way. Concerns about advisers' use of risk profiling tools resulted in the regulator publishing guidance on the matter in 2011, which highlighted examples of good and poor practice.[6] There were particular concerns about the assessment of clients 'capacity for loss' (i.e. their ability to absorb falls in the value of their investment); the use of subjective representations of risk in questionnaires, for example numeric scales or ill-defined terms; unclear question wording; and an over-reliance by advisers on the automated output of risk profiling tools, rather than using the output as the basis for discussion with the client. Three years on from the publication of the guidance, risk profiling continues to be a cause for concern for the regulator.[7]

## What information do Attitude To Risk (ATR) questionnaires capture?

We analysed a sample of Attitude To Risk (ATR) questionnaires to find out the types of questions they ask and the sorts of information they capture. Among the eleven questionnaires that we looked at, the number of questions asked in each questionnaire ranged from five up to 25. Most of the questionnaires ask at least ten questions.

The questionnaires aim to capture four key aspects of an individual's risk profile:

1. **Willingness to take risk**
2. **Risk capacity**, which is someone's *financial ability* to take risk
3. **Risk need**, which is the *need to take risk* to achieve desired outcomes or goals, and
4. **Experience and expertise** when it comes to financial matters.

[6] *Finalised Guidance, Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection.* FSA, March 2011

[7] 'FCA: We still have concerns about risk profiling', Money Marketing, 14/05/14

In Table 1 below, we have grouped individual questions into a number of sub-categories that sit below the four elements of someone's risk profile (willingness to take risk, risk capacity, risk need, experience and expertise).

Perhaps not surprisingly, the table shows that ATR questionnaires focus mainly on capturing someone's willingness to take risk in a range of different ways, including through psychological measurement (also called psychometrics). As a result, the most questions in any risk profile questionnaire are devoted to willingness to take risk. By comparison, there are fewer questions about risk capacity and risk need – although these questions may be weighted more heavily in the scoring. It is also expected that the customer's ability to take risk, along with their financial needs, are explored in depth with the adviser alongside the results of the ATR questionnaire. The results from the ATR questionnaire are played back to customers in writing too.

**Table 1: Attitude To Risk questionnaires deconstructed**

| WILLINGNESS TO TAKE RISK | RISK CAPACITY | RISK NEED | EXPERIENCE AND EXPERTISE |
| --- | --- | --- | --- |
| • Risk-self-identification<br>• Whether risk has +VE or -VE associations<br>• Loss aversion<br>• Past experience of financial risk taking<br>• Willing to take risk to achieve returns?<br>• Comfortable making riskier investments?<br>• Willing to trade certainty for returns?<br>• Portfolio preference<br>• Likely reactions to investment loss<br>• Extent of loss that's acceptable? | • Likely need to access money invested<br>• Capacity for loss<br>• Time horizon | • Willing to accept losses to achieve long-term rewards?<br>• Willing to trade certainty for returns? | • Confident about making financial decisions?<br>• Self-identifies as experienced investor?<br>• Understands financial matters? |

## Risk profiling: room for improvement?

> 'It is often difficult for clients to describe in their own words their attitudes about risk.'
>
> Callan and Johnson, *Journal of Personal Finance,* Vol 1, Issue 1, 2002

Specialist providers of risk profiling tools are a well-established part of the UK's financial services landscape. Attitude To Risk questionnaires have been developed, tested on large numbers of clients and refined over time, with input from experts and academics. On the product side, savings and investments are labelled in ways that are designed to make it easier to match an individual to an appropriate product.

In terms of room for improvement, there is certainly scope to improve the wording of ATR questions (and their response codes) to make them easier for the average person to understand. Likewise, there may well be ways to improve the risk profile labels and product categorisations that firms currently employ.

These types of improvements may help financial firms demonstrate to the regulator that they are working to improve their assessment of suitability processes. And they may make life easier for individual advisers in their interactions with clients, if for example they have to spend less time translating ATR questions into something that clients can understand and answer. The client also benefits, in as much as any improvements can help ensure that they buy a savings or investment product that matches their risk profile.

What these improvements cannot do, though, is help people think about, engage with, and better understand the range of financial risks that they may be exposed to, and in turn help them better understand their own attitude to risk in a way that makes most sense to them.

At a time when the idea of 'self-service' saving and investing is gaining ground and people have new freedoms (for example how they can use their private pension saving and how much they can save and invest tax-free), we need fresh thinking about how to encourage the average person to consider the financial risks they face in their lives, how to help them think about and describe their own attitude to risk, and how they can use this knowledge when they save and invest.

We know from social psychology, for example, that any attitude has a spoken component (beliefs) but also unspoken components (feelings and emotions).[8] While Attitude To Risk questionnaires touch upon the unspoken components of someone's attitude to risk, arguably a better understanding of the feelings and emotions that come into play in saving and investing, and how they affect people's decision-making, could improve the outcomes for individuals in both advised and non-advised purchases. Research with professional traders has also shown links between investment performance and how they regulate their emotions that could be relevant to individual investors.[9]

[8] Secord PF and Backman CW (1964) *Social Psychology*. New York: McGraw-Hill

[9] Fenton-O'Creevy, M, Soane, E, Nicholson, N and Willman, P (2011) *Thinking, feeling and deciding: the influence of emotions on the decision-making and performance of traders.*

## New research, fresh thinking

Our new research study aims to bring fresh thinking to this important and topical issue. We focus on four key questions:

1. What do people understand by the term 'risk' in relation to saving and investing and what informs this understanding?
2. To what extent do existing risk profile tools reflect people's own understanding of risk?
3. Is there scope to improve risk profiling to provide a better indicator of people's attitude to risk?
4. Is it possible to develop a tool that consumers could use themselves? What would this look like?

To answer these questions, we plan to conduct in-depth interviews with policymakers, consumer organisations, and the general public over autumn 2014. The insights from the research will be presented at a Round Table event, designed to take forward fresh thinking into policy and practice.

## Join the conversation

If you're interested to share your views and experiences of risk profiling, get in touch via Twitter **@PUFin_Sharon #riskresearch**

## About PUFin

The True Potential Centre for the Public Understanding of Finance (PUFin) is based at The Open University Business School (OUBS). PUFin is a pioneering centre of excellence for research and teaching related to personal finance capability. It brings together academics with expertise in fields such as regulation, taxation, consumer attitudes, motivations and behaviours, and social marketing.

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This research project is led by Sharon Collard, Professor of Personal Finance Capability at PUFin, working with Ian Costain (independent consultant) and QRS Research.