Nucleus white paper

Risk management for financial advisers

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Risk management for financial advisers

The industry sea change that is being created by the Retail Distribution Review is going to result in a great deal of business model modification as financial advisory firms review key parts of their proposition. Aspects such as fee models, investment solutions, client segmentation, platform usage and their overall commitment to independence.

97%

of Nucleus advisers are very or extremely confident about their business over the next three years.

Added to this, it's clear that in doing so advisory firms will take greater control of the different elements of the supply chain supporting their client propositions. The days of firms being viewed as a distribution mechanism by the traditional life companies are all but over. All of these factors are leading to a significant amount of new solutions being adopted across the industry.

The good news is that results from the Nucleus 2012 IFA census have shown that advisers using Nucleus are very positive about the future: 97 per cent are very or extremely confident about their businesses over the next three years, despite the current economic climate. Additionally, 85 per cent view the RDR as an opportunity and complementary to their business model.

Amid all of this evolution and optimism, it's important to pause and consider governance issues and particularly how adviser firms improve their approach to risk management. Risk management is the process of identification, assessment and management of risks in a firm with the aim of controlling threats and maximising opportunities.

Risk management is the process of identification, assessment and management of risks in a firm with the aim of minimising threats and maximising opportunities.

Where change remains the only constant in our industry, it's important we have the tools at hand to help us manage risks within our businesses and spot the potential impacts as early as possible.

This paper is therefore intended as a tool to prepare advisory firms in understanding business risks, focusing specifically on the current and emerging UK market and regulatory environment. It sets out techniques to identify, assess and manage risks across a range of critical business categories.

We hope that advisory firms will find the paper a useful tool as part of their continued success in the new-look financial services industry.

The paper has been prepared in conjunction with the Nucleus IFA Advisory Board and Compliance & Training Solutions Ltd (CATS). CATS specialises in providing compliance support to financial planning firms and looks after a number of Nucleus users.

What is risk management?

Almost everything we do in business involves risk of some kind whether it's operational, regulatory or client orientated. It's impossible to service our clients and generate profit without undertaking some level of risk – it's a fundamental principle of business life. Risk management doesn't principally focus on how to entirely eliminate risk, rather to manage the risks involved to maximise opportunities and minimise adverse effects. The challenge that we all face is to not only identify the risks but also ensure we have plans in place to prepare for them and respond if necessary.

Adopting a risk management framework provides your business with a structure to identify, record and monitor potential risks so that they can be managed effectively to control any disruption to the delivery of your client proposition.

There are many benefits to operating a well-executed risk framework including:

1. Fewer shocks and unwelcome surprises
   Having a greater awareness of significant risks should reduce the likelihood of failing to identify a problem until it's too late. Reputational damage with clients as well as negative financial consequences and regulatory issues can be costly to the health of your business. Early identification of threats empowers a business to categorise and prioritise risks and to deal with them in a timely and effective way.

2. Personal accountability is more visible
   Once you're clear about the risks that sit within your business, it would normally be appropriate to assign the responsibility to the most relevant member of your team, or perhaps even an external expert to deal with them. A robust risk management process will mean that once allocated, a risk can be monitored to ensure it's dealt with effectively. An improvement in the quality of your regular decision making should also be a benefit.

3. The discovery of new revenue opportunities
   Promoting continuous improvement by identifying and dealing with risks will often lead to the discovery of new commercial opportunities that may otherwise have been missed. The overall process of considering risks will naturally lead you to question your existing business processes and explore alternative ways of doing things.

4. Preparation, organisation, discipline!
   A strong risk framework should support your strategic and business planning to make sure it's calibrated to the specific needs of your business, clients and also the regulator. It's imperative that you move beyond simple discussion and the identification stage to develop the discipline of clearly documenting the issues you think may arise. You need to do this in a way that demonstrates that you have thoroughly considered the impact and likelihood of a risk and have a structured plan to mitigate a potential problem.

5. Building additional shareholder value
   The ability to demonstrate embedded corporate governance and greater regulatory adherence could improve the value of your business to a potential purchaser. Maintaining a detailed and accurate risk matrix provides the buyer with an understanding of the problems that may befall their new purchase, which should be reflected positively in the price.

6. Client confidence
   Maintaining a thorough risk management process further demonstrates your commitment to treating customers fairly.

The FSA

The FSA has of course always shown interest in risk management practice among advisory firms, but this focus is intensifying in the lead-up to the RDR. This feels natural given the increased control advisers exercise over client outcomes.

At the end of 2010, speaking at a Platforum conference, Rory Percival of the FSA said "To a greater or lesser extent, intermediary firms are changing their business model, usually at least in part in response to the RDR. Where business models change, firms are in a new place, and they have new or different risks. It is of particular concern that among the 12 firms that we reviewed, not one had adequately reviewed their management and oversight in light of the changes they had made. In most cases they had not considered this issue at all and this is simply not acceptable."

With this in mind, the FSA is regularly carrying out business risk awareness workshops throughout the country. These will be followed up by further workshops and interviews (either face-to-face or telephone) to discuss with the principal of the firm governance, controls, culture and how this can be evidenced by procedures that are in place.

Furthermore, risk management is also seen as a key management competency. This is a theme that is either explicit or implicit running through the majority of FSA publications, from guidance consultations through to policy statements.

Tip – regulatory fines

While risks are by no means limited to the regulatory environment we have summarised some of the recent key themes for regulatory fines imposed during 2011 and 2012:

- Failure in money laundering controls
- Client money protection failures
- Failures in corporate governance arrangements in an authorised and regulated firm
- Failure to manage conflicts of interest
- Failure in client communications and sales processes
- Failure to prevent internal frauds
- Failure to meet DPA requirements
- Failure in client communications/financial promotions
- Failure in meeting compliance requirements as an authorised/regulated firm or individual
- Failure in systems and controls/failure to establish appropriate systems and controls

Establishing a risk management framework

There are many different approaches to creating an effective risk management framework within your business, but most tend to broadly focus on four key stages as detailed in the diagram below.

Stage one – Identification of risks

The identification of the risks within a business can be approached in a number of ways. Given that we operate in a highly regulated environment initial consideration should be given to regulatory guidance, especially any recent policy papers.

Interviewing members of staff to understand the key dependences on their ability to achieve their objectives can also be extremely beneficial. Many firms chose to undertake a brainstorming session with all key staff present to provide an initial list of potential negative outcomes. This method also ensures everyone is involved and encouraged, at an early stage, to consider risk as a day-to-day element of their role. This paper provides examples of specific risks that can often be found within financial advisory practices.

Stage two – Assessment of impact

Once the key risks have been determined it's normal practice to prioritise those that have the potential to be most damaging to the business and/or display a high likelihood of occurring.

The benefits of creating strategies to deal with the risk are maximised if the solution becomes an integral part of all your organisational processes, and you thoroughly address all uncertainties and assumptions in the delivery of process improvements.

Stage three – Implementation of risk controls

It could be very easy to view a risk management framework as another layer of business bureaucracy and many staff may initially be reluctant to acknowledge the benefits it can bring if correctly implemented. Attempts to embed risk management into the culture of the business can fail if you do not succeed in securing the initial buy-in of stakeholders, which means it's imperative to involve them early in the process.

Remember, effective risk monitoring should improve the working environment and help employees to deliver their objectives so make sure you keep them engaged.

Try and keep the process as simple as possible and ensure any supporting management information is relevant and practically useful.

A strong awareness of prevailing risks is a benefit at all levels of the business so ensure the relevant information is cascaded down effectively to all employees.

Their involvement should be ongoing and all employees should be encouraged to report any emerging risks and be rewarded for suggestions that mitigate or eliminate existing risks.

And finally, when implementing policies it is important to consider the cost of the actions you are proposing and make sure that they are equal to the size of the risk you're looking to address.

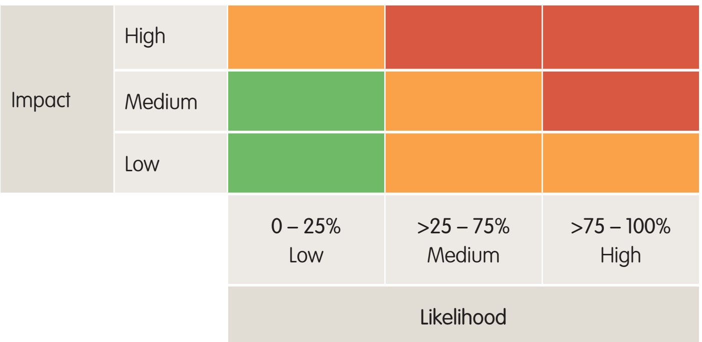
Establishing a risk management framework, cont'd

Stage four – Record, evaluate and monitor

Identifying risks and putting in place initial controls are key steps to embedding a robust risk framework within your business. However, they will almost certainly fail to deliver any long lasting benefit unless they are properly documented and formally reviewed on a regular basis.

The following section proposes a structure for a risk register. In addition you may wish to consider creating a risk heat map that visually portrays the priority of risks across the business.

A heat map is simply a two-dimensional representation of data in which values are shown by colours to provide instant priority of risks. As you refine your approach to risk management you may wish to consider adding definitions to quantify the terms, as demonstrated in the chart below.



Typical heat map definitions:

Red risk	These are classed as primary or critical risks requiring immediate attention. They may have a high or medium impact or probability of occurrence, but their overall severity warrants their treatment as a high priority. This may mean that strategies should be developed to reduce or eliminate the risks or mitigation in the form of contingency planning and the risk monitored on a regular frequency.
Amber risk	These risks are classed as significant. They may have a high/medium or low impact or probability of occurrence but their overall severity is regarded as sufficiently serious to warrant appropriate consideration. As above, strategies should be developed to reduce or eliminate the risks or mitigation in the form of contingency planning and the risk monitored on a regular frequency.
Green risk	These risks are less severe but may cause upset and inconvenience in the short term. These risks require minimal monitoring unless subsequent risk assessments show a substantial change in their probability of occurrence or impact.

Creating your risk register

The format of a good risk register will vary depending on the requirements of the business. It should be a working document so consider the process for regularly updating it.

You may wish to include the following:

ID	Give each risk a unique identifier using a naming convention that can be consistently applied across the whole register and can be easily understood by the users.
Description	Provide a title and brief description of the risk and its potential impact. You may wish to outline some basic background to your assumptions.
Risk originator	Who identified the risk?
Risk owner	Who is responsible for the management and monitoring of this particular risk? It's important to create transparent accountability.
Risk opened	The date the risk was identified/raised.
Financial impact	Determine the financial cost to the business of the risk occurring.
Probability	How likely is it that this risk will occur? This could be recorded as a percentage or on a simple 1 – 5 scale.
Heat map grading	Enter the score produced by the heat map analysis.
Risk controls	Once the risk has been identified you have to decide how you're going to treat it. Each of these options should be documented in enough detail for anyone reading the log to understand. In some instances these may refer to an additional, more detailed, breakdown.
Agreed actions	So, you've decided how you'll treat the risk but now you need to clearly define your approach. Don't go overboard in your description but ensure you have enough detail for it to be useful to another party who may read the content.
Risk closed	The date the risk was no longer deemed to be an active threat.

Financial impact

All risks come with a quantifiable financial impact even if it's not immediately apparent. A significant decrease in staff morale has no immediate financial cost but may have in the longer term if staff retention becomes an issue, client service deteriorates and clients are lost. It may take additional work to determine the financial impact but it's clearly important to fully understand the impact on your business of a negative event occurring. A clearer understanding of the financial impact is likely to improve your prioritisation of resources.

Risk controls can be broadly defined into five possible strategies:

Mitigation – achieving a reduction in the likelihood of the risk occurring. Essentially this means actively planning additional activities that are undertaken before the risk exposure window to lessen its impact/probability.

Avoidance – take action in advance of the risk exposure window to reduce the likelihood of the impact to zero.

Acceptance – understand the risk and accept that it may take place. This will usually happen when the impact (in the event of the risk occurring) is minimal.

Transference – moving the impact of the risk to another party. This type of treatment isn't possible in all circumstances, but could be achieved by outsourcing.

Contingency – this final type of treatment is one of the most common, in that it involves planning a response to the risk that can be actioned immediately if the risk should take place.

Five key areas of potential risk in advisory firms

The current market and regulatory environments in relation to any business sector always influence areas of risk, and this is certainly no different for advisory firms in the lead up to the RDR and beyond.

To help you develop your own risk matrix we have set out five key areas in more detail that have been highlighted by Nucleus advisers as potential areas of concern. However, this is by no means intended as a definitive list – some of these areas may or may not apply to your firm, and if they do, impact and priority will differ by firm; no two businesses are the same or have the same priorities. The tables also provide examples of coping strategies you may wish to consider.

Key

Impact category	Description
Strategic	Weakens the firm's client proposition to market, and/or ability to deliver it effectively, or ability to meet the strategic objectives of the business.
Financial	Negative impact on profitability or introduction of additional costs to the business.
Client retention	A negative impact on the charges the client pays, the service they receive, or meeting of their financial objectives.
Regulatory and legal	Adviser firm falling foul of regulations or the law.
Reputation/brand	Could negatively impact the public reputation or brand of the firm, which could lead to business detriment.
Operational	Would introduce additional resource requirements to the business in order to rectify the situation.

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Client bank

Risk	Main impact category(s)	Possible management responses
Failure to attract new clients	Financial, strategic	Carry out proposition benchmarking. Improve marketing plan. Focus on increased revenue opportunities from existing clients. Review cost base to neutralise loss of revenue.
Failure to retain existing clients	Financial, strategic	Develop a process to capture structured client feedback. Understand financial impact. Review client value proposition.
Service proposition misaligned to client segment	Strategic	Analyse profitability of service delivery. Redefine service proposition. Consider client communication strategy.
Acquiring unsuitable clients	Operational, reputation	Measurement of financial and operational impact. Create a disengagement strategy with supporting communications plan.
Weak client communications	Regulatory and legal, reputation	Carry out proposition benchmarking. Improve marketing plan.
Post-RDR advice proposition is not clear	Regulatory and legal, strategic	Review disclosure documents on a regular basis. Create questionnaire to measure client awareness.
Failure to clearly evidence the delivery of independent advice	Regulatory and legal, reputation	Strengthen compliance resource. Refine client proposition aligned to the regulatory requirement.
Impact of direct-to-client propositions	Financial, strategic	Make clear client offering, charging structure, and the benefit of advice.

Five key areas of potential risk in advisory firms, cont'd

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Tools

Risk	Impact category(s)	Possible management responses
Commercial bias in advice process	Regulatory and legal, client retention	Undertake regular due diligence on third party supply chain components. Create and monitor KPIs. Develop file checking processes.
Inaccurate output	Regulatory and legal, client impact, reputation	Pre-adoption and regular quality checking. Improve training for support staff/ advisers. Improve client data capture to optimise inputs.
Client suitability failure	Regulatory and legal, client retention	Analyse file checking results, monitor CPD activity and carry out skill assessments. Link the advisers to quality controls that impact remuneration.
Withdrawal of tool by provider	Operational	Regular due diligence of market to establish back-up choice. Extract client data backup.
Price increase	Financial, strategic	Establish a robust, transparent revalidation process. Carry out regular due diligence of market to establish alternative options.
Change of ownership	Operational	Carry out regular due diligence of market to establish alternative options.
Lack of integration	Operational	Pre-adoption and regular assessment of integration with rest of proposition.
Regulatory misalignment	Regulatory and legal	Carry out regular due diligence of market to establish alternative options.

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Investment solutions

Risk	Impact category(s)	Possible management responses
Underperformance v expectations	Client retention	Develop a continual strategy for client education and communication. Carry out regular due diligence of market to establish alternative approach.
Fund group merger/closure	Operational	Establish a robust, transparent revalidation process. Carry out regular due diligence of market to establish alternative options.
Fund manager departure	Operational	Robust revalidation process, regular due diligence of market to establish alternative options.
Regulatory toxicity	Regulatory and legal	Create process for the analysis of regulatory requirements, regular due-diligence.
Material change in pricing	Operational, strategic	Regular due diligence of market to establish alternative approach if necessary.

Five key areas of potential risk in advisory firms, cont'd

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Platforms

Risk	Impact category(s)	Possible management responses
Platform closure	Operational, strategic	Insist on sight of financial performance and sustainability, carry out regular due diligence of market to establish alternative options.
Administration failure	Operational, client retention	Understand platform service level agreements, plan to narrow client proposition to minimise impact of a failure. Benchmark service, substitute platform. Prepare client communication strategy.
Integration issues	Operational, client retention	Thoroughly assess integration with wider proposition prior to adoption.
Material change in pricing	Strategic, client retention	Implement a secondary platform. Consider additional areas where neutralising costs could be made.
Investment proposition constraint	Operational	Ensure cultural alignment with platform, regular due-diligence.

Five key areas of potential risk in advisory firms, cont'd

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Staff

Risk	Impact category(s)	Possible management responses
Loss of key individual/unplanned absences	Operational	Key man insurance, locum agreements in place for specialist advice areas, ensure adequate notice periods are in place, have succession plans in place, robust recruitment and selection techniques, sickness absence policy.
Fraud – internal financial	Regulatory and legal, reputation	Regular file checks, regular training on: anti-money laundering, the bribery act, data protection, conflicts of interest.
Fraud – recruitment	Regulatory and legal, reputation	Introduce application form as part of recruitment process, complete background checks on all new staff.
Data security	Regulatory and legal, reputation	Ensure adherence to, and awareness of, all data protection regulations. Consider engaging with a third party to carry out a security audit.
Competency or qualification failure	Regulatory and legal, operational	Staff training, skills matrix in place, skills assessments via role plays or observed calls, regular checks of CPD files, plan in advance of new requirements coming into force, operate a qualifications matrix.
Knowledge concentration	Resource/admin cost, strategic	Regular knowledge tests, regular reviews of CPD activity, leadership and management development and training, knowledge sharing mechanisms.
Morale and retention	Strategic, operational	Benchmark remuneration and benefit packages, communication methods, social events, clarity over role and purpose.
Health and safety or employment law failure	Regulatory and legal, operational	Staff training, external support, health and safety policies, implications in relation to corporate manslaughter, staff handbook, key policies and procedures, staff training, equal opportunities statement and training, sign up to free-of-charge email updates from local employment law specialists.

What now?

If you would like to discuss anything in this document or find out more about Nucleus, please contact one of our regional business development directors.

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