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BUILDING PROPOSITIONS

FCA Article: Undertaking Cashflow Modelling To Demonstrate Suitability Of Retirement Related Advice

March 2024.

Analysis Series

INTRODUCTION

The Regulator has explored the use of cash flow modelling (CFM) in Thematic Review TR24/1 Retirement Income Advice (March 2024), they did state: *There is no specific requirements for a firm to use CFM. (TR24/1 S2.12)*

However TR24/1 also suggests: *CFM has a significant role to play in helping to illustrate how much income could be drawn in a sustainable manner for the duration of the customer's lifetime, taking into account their circumstances and the size of their pension savings. (TR24/1 S 2.11)*

Within the Thematic Review 810 firms from a total of 962 used CFM, so it's safe to say CFM are widely used. The FCA then published an article entitled Undertaking Cashflow Modelling To Demonstrate Suitability Of Retirement Related Advice giving further guidance.

The article is just over 2,400 words. This Analysis Series document is condensed to just over 1,500 without losing intent or direction. Open Door Policy recommend that you read the full article in conjunction with this abbreviated version.

There are five main areas and from a helicopter point of view, it's logical and practical.

- Relying on information without considering accuracy
- Using justifiable rates of return
- Planning for uncertainty
- Consumer understanding
- Consider the output

The article is great guidance, however we also want to suggest how to use it practically within an advice model so you will also find an example checklist.

The article is an important document and part of a collection of publications which inform the development of several key areas within the advice process. These are the consultancy areas that Open Door Policy can provide to advisory firms and support services.

- Value and Charging Proposition (VCP)
- Centralised Investment and Retirement Proposition (CIRP)
- Consumer Duty Proposition (CDP)

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FCA ARTICLE: UNDERTAKING CASHFLOW MODELLING TO DEMONSTRATE SUITABILITY OF RETIREMENT RELATED ADVICE

The FCA identified concerns about how firms prepare and use cashflow modelling. The outcomes can help clients understand how income could be affected but if used incorrectly, it can create misunderstanding and unsuitable advice. Foreseeable harm can be caused if firms:

- do not consider how clients will interpret the output
- project forward using returns that are unjustified resulting in unrealistic outcomes
- do not consider the inputs and outputs objectively

Relying on information without considering accuracy

A firm is entitled to rely on information provided by clients. It is expected that firms consider if client information is consistent with goals or expectations. Examples:

- not challenging clients on figures provided (e.g. where income and expenditure indicate savings, but the client has no savings)
- not thinking about future lump sum needs (e.g. to replace cars or carry out home maintenance)

How can firms improve

Use complete, accurate and up-to-date information. Firms should check:

- they have a reasonable basis for the estimated present and future expenditure taking into account
    - the basic cost of living
    - desired lifestyle expenditure
    - discretionary expenditure
    - savings
- personal circumstances and lifestyle changes throughout retirement and how this might affect future expenditure
- they are using up-to-date salary information and identify surplus/deficits in household budgets
- salary information takes account of the method for paying workplace pension contributions (e.g. net pay, salary sacrifice and relief at source)
- the inclusion of all sources of income
- the use of up-to-date market values of assets
- they can justify estimated figures used in the projection
- they have taken into account advice given on a single life or joint life basis

Using justifiable rates of return

The returns used is one of the most important parts of the model. The expectation is that reasonable and justifiable assumptions are used. If modelling is based on incorrect assumptions, there is a higher risk of poor consumer outcomes. Examples:

- high returns assumed for cautious assets
- projections based entirely on past performance, without considering expected future potential
- not taking tax into account
- not considering how charges will affect returns
- failing to account for all product and adviser charges

How can firms improve

The base scenario for cashflow modelling should:

- use rates of return which are aligned with the investments
- be consistent across similar assets held in different wrappers
- apply appropriate tax rates

Setting future rates of return, firms:

- should make assumptions which are not based solely on specific patterns of past returns
- may use constant rates of return for different funds or asset types
- should consider the differential between gross returns and inflation
- should regularly review assumptions used, accounting for wider economic circumstances
- should be careful about presuming their ability to predict variable future rates of return (and inflation) to avoid the impression of accuracy
- should be able explain to clients the justification for any assumptions and why they are reasonable

Include all charges, considering:

- All product and adviser charges.
- The effect of charges on fund sustainability
- How costs are communicated, so the client:
    - understands how charges affect sustainability
    - can make an effective decision on whether to proceed

Planning for uncertainty

If a client understands that returns are based on assumptions about market volatility they are less likely to over-withdraw.

Firms are required to assess investment knowledge and experience and to check the understanding of risk. If cashflow modelling is not clearly explained it may not align with risk tolerance and capacity for loss. Examples:

- mixing real and nominal terms
- only planning for average life expectancy, when 50% of people will live longer than this
- failing to properly stress test outcomes

How can firms improve

Use real terms consistently. Expressing future income and expenditure in today's terms makes it easy to compare current and future lifestyles. Firms should:

- illustrate net of tax and in real terms (representing annual inflationary increases as a constant real amount)
- check whether inputs are in nominal or real terms and convert nominal terms to appropriate real terms
- be clear whether quoted returns are gross or net of inflation
- review inflation rates on a regular basis
- show the effect of alternative rate(s) of inflation

Plan beyond average life expectancy. Half of consumers will live longer than average. The ONS provides a life expectancy calculator. It takes account of how this might change for people born in different years. Firms should:

- remember that consumers generally underestimate their own life expectancy
- focus on the probability of survival rather than life expectancy
- when advising couples, consider the probability of survival for both parties
- consider how income needs may change
- only take account of limited life expectancy when there is strong evidence that it will be borne out in practice

Undertake stress testing. There is a risk of perceiving projections as certainty, so showing alternative scenarios supports the understanding of risk tolerance and capacity for loss. Firms should consider:

- illustrating a rare but feasible fall in asset values at the start of any income withdrawal period
- reducing (net of inflation) rates of return to show the impact on how long funds will last
- highlighting the lower percentile outcomes in stochastic modelling output
- showing how higher withdrawals will deplete the fund sooner

Consumer understanding

Using multiple growth rates across different communications is likely to confuse clients and lead to misunderstanding if not explained. Example:

- risk profiling tools often refer to the potential returns of the selected risk profile or the percentage fall a client may be willing to accept
- key features illustrations will show projections where the pension provider has selected a rate of return which is aligned with the underlying assets
- cashflow models will have their own assumed growth rates, which could be different from the above

How can firms improve

Consider consistency of communications, when presenting outcomes, firms should:

- be aware of differences in communications and the impact on consumer understanding
- explain why the cashflow modelling outcomes differ from those in other communications, and the inherent uncertainty in all projections
- indicate how far the outcomes are aligned to attitude to risk and capacity for loss
- be able to explain why different communications show funds lasting for different amounts of time

Consider the output

Firms need to review cashflow modelling outputs to draw conclusions about the potential financial position before and during retirement. If the firm fails to review:

- the model may be factually incorrect or misleading
- it may recommend an unsuitable solution
- there is a higher risk that the financial plan will not work out as intended
- it raises the risk of misunderstanding and poor consumer outcomes

Examples:

- a model relying on pensions being accessed before the minimum pension age
- a model relying on illiquid assets, such as a residence, for lifestyle expenditure
- not considering the impact of tax consequentially taking more from the fund than is projected

How can firms improve

Review cashflow modelling outputs. Firms should:

- consider how long funds last under the base scenario.
- review the stress testing scenarios and what they would mean for retirement income against their expenditure.
- consider how the model handles potential tax liabilities.
- check how the software handles expected increases in expenditure (e.g. university funding or mortgage repayments).
- ensure the model does not presume the client can access pensions before the minimum pension age.
- consider if there are benefits to paying more into a pension.
- review whether aims such as paying off a mortgage can be met more efficiently (e.g. by using tax-free cash).

USING CASH FLOW MODELLING (CFM)

The outcomes from a CFM can help clients understand how income could be affected but if used incorrectly, it can create misunderstanding and unsuitable advice. Foreseeable harm can be caused if firms:

- do not consider how clients will interpret the output
- project forward using returns that are unjustified resulting in unrealistic outcomes
- do not consider the inputs and outputs objectively

This document is designed as a check against the use of a CFM to ensure all areas are considered in a clear and fair manner in order to promote good client outcomes.

Consideration: Relying on accurate client information	
Check	**Yes / No / Additional Comments**
Up to date estimates for present and future expenditure, taking into account: • the basic cost of living • desired lifestyle expenditure • discretionary expenditure • savings	
Recorded personal circumstances and lifestyle changes throughout retirement and how this might affect future expenditure	
Up-to-date salary information and identify surplus/deficits in household budgets	
Taking into account of the method for paying workplace pension contributions (e.g. net pay, salary sacrifice and relief at source)	
All sources of income included	
Use of up-to-date market values of assets	
Is there justification for the estimated figures used in projections	
Accounting for advice given on a single life or joint life basis	

Consideration: Using justifiable rates of return	
Check	**Yes / No / Additional Comments**
The base scenario uses rates of return which are aligned with the investments	
The base scenario is consistent across similar assets held in different wrappers	
The base scenario applies appropriate tax rates	
Future rates of return are not based solely on specific patterns of past returns	
Future rates of return use constant rates for different funds or asset types	
Future rates of return consider the differential between gross returns and inflation	
Future rates of return regularly reviewed accounting for wider economic circumstances	
The client is aware that future rates of return and inflation are assumptions to avoid the impression of accuracy	
The client is aware of justification for any assumptions and why they are reasonable	
All product and adviser charges are considered	
The client is aware of effect of charges on fund sustainability	

Consideration: Planning for uncertainty	
Check	**Yes / No / Additional Comments**
Future income and expenditure is expressed in today's terms	
Projections are illustrated net of tax and in real terms (representing annual inflationary increases as a constant real amount)	
Inputs are in real terms and nominal terms are converted to the appropriate real term	
The client is aware of whether quoted returns are gross or net of inflation	
Inflation rates are reviewed on a regular basis	
The mode shows the effect of alternative rate(s) of inflation	
The client understands and does not underestimate their own life expectancy	
The focus is on the probability of survival rather than life expectancy	
Regarding couples, the probability of survival for both parties is considered	
Changing income needs is considered	
Limited life expectancy is only considered when there is strong evidence that it will be borne out in practice	
When stress testing, there is an illustration of a rare but feasible fall in asset values at the start of any income withdrawal period	
When stress testing, there is an illustration of reducing (net of inflation) rates of return to show the impact on how long funds will last	
When stress testing, the lower percentile outcomes in stochastic modelling is highlighted	
When stress testing, the client is aware of how higher withdrawals will deplete the fund sooner	

Consideration: Consumer understanding	
Check	**Yes / No / Additional Comments**
When reviewing cashflow modelling outputs, how long funds last under the base scenario is considered	
When reviewing cashflow modelling outputs, consideration is given to what they would mean for retirement income against expenditure	
When reviewing cashflow modelling outputs, how the model handles potential tax liabilities is considered	
When reviewing cashflow modelling outputs, how the software handles expected increases in expenditure is checked	
When reviewing cashflow modelling outputs, the model does not presume the client can access pensions before the minimum pension age	
When reviewing cashflow modelling outputs, consideration is given to whether there are benefits to paying more into a pension.	
When reviewing cashflow modelling outputs, consideration is given to whether aims such as paying off a mortgage can be met more efficiently	

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