Mastering FCA Retirement Income Advice Thematic Review

A Guide to Cashflow Modelling

This document will be of interest to:

- advisory firms providing retirement income advice, including defined benefit transfer advice
- advisory firms offering broader investments advice
- regulatory compliance consultants.

Created for financial professionals, this comprehensive guide navigates the Financial Conduct Authority (FCA) Retirement Income Advice Thematic Review (TR24/1), highlighting the pivotal role of cashflow modelling techniques. It strongly emphasises the use of techniques and strategies that not only meet but exceed the FCA's expectations and industry benchmarks, empowering advisors to excel in retirement planning.

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Recap of areas of improvement

The FCA Retirement Income Advice Thematic Review has highlighted five crucial areas for improvement that are of utmost importance to advisers.

1. Income withdrawals: Ensure personalised approaches and justified methods for income withdrawals tailored to individual circumstances
2. Risk profiling: Evidence-based risk assessments aligned with client objectives and knowledge.
3. Customer information: Gather necessary data to demonstrate advice suitability
4. Periodic Reviews: Consistently deliver relevant periodic reviews to customers who have paid for ongoing advice.
5. Record-Keeping: Maintain accurate and sufficient records to assess customer outcomes and track service delivery.

We're here to provide the necessary support for addressing these key areas effectively, ensuring your methods align seamlessly with the FCA's expectations and industry standards. This empowerment will equip you with the confidence to deliver the best possible service to your clients.

> **“Advisers’ failure to review their cashflow tools could lead to customers receiving unsuitable advice”, the FCA has said.**

Let’s redefine cashflow modelling techniques

Mastering cashflow modelling is not just a skill but a fundamental requirement for providing robust and suitable advice and recommendations. In the dynamic landscape of financial regulations and client expectations, it serves as a compass, guiding you towards the best possible outcomes for your clients.

Your capacity to offer realistic projections via cashflow modelling can significantly influence your client's financial future in retirement. This powerful tool can guide your clients towards a more secure and comfortable retirement, making it a game-changer in advisory services.

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> **The FCA has emphasised the critical role of cashflow modelling in “safeguarding clients' financial well-being”. In its recent Retirement Income Advice Thematic Review, the FCA highlighted prevalent errors and misconceptions surrounding cashflow modelling practices within advisory firms.**

Errors in cashflow modelling, from tax implications to investment projections, can have severe consequences. They can lead to unsuitable advice and, ultimately, significant harm to your clients' financial outcomes. It's not just about the quality of advice but the tangible impact it can have on your clients' financial futures

Effective cashflow planning relies on projecting diverse financial scenarios based on sound assumptions and thorough analysis. When used correctly, cashflow modelling enables clients to understand the potential impacts of economic fluctuations on their retirement income, enabling informed decision-making. However, misusing or misinterpreting cashflow models can lead to a lack of clarity and misalignment between clients' objectives and advice recommendations. Your cashflow modelling expertise empowers clients to control their financial future.

Financial advisers, entrusted with clients' financial futures, must adhere to the FCA's recommendations and foster a culture of continuous improvement in cashflow planning and retirement advice. This includes planning beyond average life expectancy, a responsibility that requires diligence and foresight. Advisers can elevate the service delivery standard by undertaking a rigorous assessment and proactively refining cashflow modelling methodologies. This ensures that each client receives personalised advice tailored to their individual needs and aspirations.

Diving into the FCA's Retirement Income Advice Thematic Review findings

In this section, we'll explore the FCA's findings and recommendations regarding cashflow modelling and how we can help you seamlessly incorporate these new requirements into your existing advice processes.

Finding 1: Adviser firms rely on information without considering its accuracy

Some firms have been found to rely on client information without considering its accuracy unless they know it's outdated, inaccurate, or incomplete. Adviser firms are expected to assess whether the information provided by clients aligns with their stated retirement goals or expectations. Such assessment is crucial to providing suitable advice.

> **Examples included:**
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> - **Not challenging clients on figures provided, such as when income and expenditure suggest savings are available, but the client has none.**
>
> - **Not considering future lump sum needs, such as replacing cars or conducting home maintenance.**

- Ensure you've got a complete understanding of the estimated expenses now and in the future. This means considering your client's needs for essentials, lifestyle choices, extra spending, and savings.
- Consider how your client's lifestyle might change during retirement and affect their spending habits.
- Double-check that you use their latest salary information to determine their current income and calculate any budget surpluses or shortfalls.
- Keep an eye on how workplace pension contributions are handled in salary calculations, whether net pay, salary sacrifice, or relief at source.
- Include all sources of income from now on and until retirement, such as salary, benefits, rental income, dividends, bonuses, and pensions, and a realistic estimate of state pension.
- Ensure you're using up-to-date market values for all their investable assets.
- Be able to back up any estimated figures you use in your projections.
- Consider whether your advice is for an individual or a couple.

How can we help your advisory firm address Finding 1?

Our cashflow planning tool, EVPro Goal, delivers a range of functionality to help meet the new FCA requirements for enhancing client information-gathering accuracy.

Here are just a few of the features available within EVPro Goal:

- Allows for the entry of essential, desirable, ongoing, and one-off expenditures, with or without increase, to facilitate future expenditure planning. For instance, if a client's expenditure suggests a surplus income, but they have no savings, you can set preferences in EVPro Goal to ensure that the client spends all their surplus income. This feature provides accurate forecasting and planning, a key aspect of effective cashflow modelling.

- Enables expenditure to be adjusted over time to accommodate lifestyle changes as the client ages.
- Considers income tax and national insurance contributions when calculating net income to determine the correct income for planning.
- Accounts for tax relief on pension contributions.
- Incorporates various types of income, such as business owner dividends, benefits, and non-taxable income.
- Integrates with back-office systems and platforms to ensure that the latest valuations can be retrieved for planning purposes.
- Allows for planning based on single-life or joint-life scenarios.

Finding 2: Using justifiable rates of return

Adviser firms' investment modelling is highlighted based on incorrect assumptions, leading to a higher risk of poor consumer outcomes. Clients may need help understanding the risk of failing to achieve the required returns to meet their objectives, thus needing to be more informed.

Examples included:

- Assuming high returns for cautious assets without explanation.
- Basing projections solely on past performance without considering future potential.
- Neglecting tax implications in withdrawals.
- Overlooking the impact of charges on future returns or not accounting for all associated charges.

What do you need to consider?

Consider the potential returns
When advising your clients, it’s essential to recognise that the returns they achieve can differ depending on their investments.

So, when you're creating cashflow models for your clients, remember to:

- Use future rates of return that match the investments you'll recommend.
- Maintain consistency, especially for similar assets held in different wrappers.
- Apply the appropriate tax rates to ensure accuracy.

Use justifiable future rates of return

When setting future rates of return for cashflow modelling, it’s crucial to avoid relying solely on past performance. Instead, use assumptions encompassing a broader future view. It’s acceptable to use constant rates for different funds or assets, provided they undergo appropriate stress testing.

Factor in differences between gross returns and inflation for different assets, and regularly review and update your assumptions based on the current economic landscape. It’s imperative to communicate the rationale behind these assumptions to your clients, emphasising how they support their financial goals.

Include all charges
When planning your clients' retirement income, it's important to understand how charges can impact their investments. Just like a higher withdrawal rate can affect their funds, charges play a significant role, too.

Here are a few things to consider:

- It’s important to consider all charges. This includes not just product charges but also platform fees, product/wrapper charges, fund charges, and any additional fees associated with services like discretionary fund management or centralised investment propositions.
- Assess how the recommended solution charges will affect the longevity of your clients’ funds. Understanding this impact is crucial for ensuring their financial security over the long term.

- Ensure that you clearly communicate the overall cost to your client. This helps them grasp how the level of charges influences the sustainability of their funds. With this understanding, they can decide whether to proceed with the recommended solution.

How can we help your advisory firm address Finding 2?

To address the areas of improvement highlighted by the FCA regarding returns and charges, we can help by using forward-looking scenarios generated by the EV Asset Model. Additionally, we can evaluate charges across various parts of our cashflow planning solution.

The outputs from the EV Asset Model underpin everything we do and can help you plan for unexpected market volatility that will impact your clients' cashflow plans. The model is updated quarterly and during periods of market volatility. For example, when Brexit occurred, we generated and implemented new returns within one week, ensuring consistency and a reliable client experience across our financial planning tools.

The market turbulence of recent years is not unprecedented but arose after a long period of relative stability, moderate inflation, low-interest rates, and compound asset growth. Fortunately, our data-driven approach means our solutions support adviser users in creating financial plans tailored to clients in all market conditions.

Advisers must equip themselves with the essential tools to effectively assist clients in planning for their retirement. With EVPro, advisers gain access to the tools required to reassure their clients, providing realistic forecasts backed by advanced stress-test functionality. This tool considers both past events and future possibilities, allowing advisers to present clear information to their clients. By working collaboratively with clients, advisers can proactively adjust existing or future provisions, thus averting the shock of becoming aware of shortfalls when it's too late.

Our model has been forecasting the likelihood of significantly higher inflation for some time, along with lower projections of real returns. This helps ensure funds using our strategic asset-allocation model are well-positioned to deal with current market conditions.

Our cashflow planning tool, EVPro Goal, delivers a range of functionalities to help your advisory firm meet the new FCA requirements for using justifiable rates of return.

Here are just a few of the features available:

- Our unique approach to stochastic forecasting ensures that plans are assessed robustly and quickly, allowing plans to be adjusted based on foreseeable harm and instilling trust and confidence in our users.
- We consider income tax, capital gains tax, chargeable gains, and NIC to allow for accurate planning and consistent forecasts for the underlying assets.
- We calculate the gross amount that may need to be withdrawn from a pot to meet a net income. We adjust our forecasts to allow for tax and make assumptions for tax on investment withdrawals.
- We account for percentage and pound charges, including all product, platform, DFM, and adviser charges, and provide a range of outcomes.
- Our forecasts are based on future rates of return rather than past performance and are derived from our ESG model, which models the risk and volatility of different asset classes.
- We take into account inflation so that charts show today's values, and we update portfolios and capital market assumptions quarterly to consider current and future market conditions.
- We fully account for charges in our forecasts, as detailed above, and the effect of these deductions on the future value. Our tool and report display charges in an easy-to-read table, making it very clear if the charges have increased, decreased, or stayed the same if the client follows the adviser's recommendation.

Finding 3: Planning for uncertainty

It has been observed that there is often a need for more clarity in explaining cashflow modelling to clients, which can affect their ability to plan for the future effectively. Clear communication regarding the assumptions that underlie cashflow modelling is essential to ensure recommendations are aligned with clients' risk tolerance and capacity for loss.

Examples included:

- **Mixing real and nominal terms in cashflow modelling.**
- **Planning only for average life expectancy despite the likelihood of individuals living longer.**
- **Failing to stress test outcomes aligned with potential investments adequately.**

What do you need to consider?

Use real terms consistently
When advising clients, it's essential that they understand their current income and expenses, factoring in taxes. By helping them see their future finances in today's terms, you can paint a clearer picture of what retirement might look like compared to their current lifestyle.

Here are some steps you can take:
- Present their income and expenses after taxes, adjusted for inflation to reflect today's value.
- Ensure consistency between real and nominal values and adjust accordingly.
- Specify whether any returns you mention are before or after accounting for inflation.
- Regularly review the inflation rates you're using to keep things up-to-date.
- Demonstrate how varying inflation rates could impact their investments so they can grasp the effect inflation might have.

Plan beyond average life expectancy
It's important to consider that 50% of consumers will live longer than average. So, projections extending beyond the average life expectancy should use a cashflow model.

Here are some key things to keep in mind when working with your clients:
- Remember that clients tend to underestimate their life expectancy.
- Focus on the probability of survival rather than just the average life expectancy. This helps address clients' misperceptions and avoids the potential risk of them running out of money.
- When advising couples, consider the probability of survival for both individuals.
- Think about how income needs might change as clients get older.
- Only consider limited life expectancy when strong evidence supports it in practice.

Undertake stress testing
In client interactions, it's important to ensure they don't perceive detailed projections as absolute certainty. Instead, you can provide a range of plausible alternative scenarios that align with their risk appetite and capacity for loss. This approach not only offers evidence that the proposed risk is aligned with the needs but also helps clients understand the potential risks and outcomes of the recommended plan, especially concerning their retirement income.

Here are some considerations for you:

- Illustrate the possibility of a rare but realistic decline in asset values at the beginning of any income withdrawal phase, reflecting actual drops in benchmarks for the suggested investments.
- Adjust net-of-inflation rates of return to demonstrate how it affects the longevity of their funds.
- Highlight lower percentile outcomes from stochastic modelling to provide a comprehensive view of potential scenarios.
- Demonstrate how increased withdrawals can expedite fund depletion and clarify the consequences of higher withdrawal rates.

By incorporating these strategies, you can help your clients better understand the uncertainties and possibilities inherent in their financial plans.

How can we help your advisory firm address Finding 3?

Our cashflow planning tool, EVPro Goal, delivers a range of functionality to help your advisory firm meet the new FCA requirements for planning for uncertainties.
Here are just a few of the features available:

- We can allow users to view high and low outputs to help understand the unpredictability within their plan.
- With our EVPro Solver tools, a unique to-the-market collection of stress tests available with EVPro Goal, you can choose from 10 powerful "what-if" scenario stress tests within the client cash flow plan. Each test analyses 1,000 scenarios per stress test in just a few seconds, providing consistency across all advisers within the firm and ensuring a robust plan for each client. This allows adjustments to account for inflation, general increases, and unexpected emergencies.
- All cash flow charts are shown in today's values to account for inflation, making it easy for the client to understand.
- With joint planning, we calculate the plan end date based on the second person's death and allow for adjustments to account for longevity. We have a stress test around longevity to check the robustness of the plan if the client lives longer. Users can also adjust the life expectancy to account for people who think they will live longer.

Finding 4: Improving consumer understanding

Clients receiving advice may encounter various communications from firms referencing future outcomes. However, using multiple growth rates across different communications without explanation can confuse clients and lead to misunderstanding.

Examples included:

- **Risk profiling tools refer to potential returns or percentage falls without clarification.**
- **Key features illustrations showing projections based on rates selected by pension providers, which may differ from other growth rate assumptions.**
- **Cashflow models employ assumed growth rates, potentially different from those in other communications.**

What do you need to consider?

Consider the consistency of communications
When presenting cash flow modelling outcomes to your clients, remember to:

- Be mindful of the power of effective communication and how it influences your clients' understanding.
- Emphasise the reasons behind differences in cash flow modelling outcomes and the inherent uncertainty in all projections.
- Align scenario outcomes with your clients' attitude towards risk and capacity for loss.
- If necessary, clarify why various communications indicate differing durations for your clients' funds.

How can we help your advisory firm address Finding 4?

Our cashflow planning tool, EVPro Goal, delivers a range of functionality to help your advisory firm meet the new FCA requirements for improving consumer understanding.

Here are just a few of the features available:

- EVPro uses a single calculation engine to ensure the consistency of recommendations and a reliable client experience across all of our financial planning tools.

- Forecasts are based on your clients' funds underlying asset classes, with options to visualise strong, average, or weak outcomes. This approach demonstrates the potential diversity of returns without relying on a specific rate of return.
- The Cashflow reports available are simple reports, replaying the relevant information that has been added into EVPro. However, they do have some tailoring available to ensure that clients can handle information.

Finding 5: Consider the output

Firms are reminded to review cashflow modelling outputs to assess clients' potential financial positions before and during retirement. Failure to review outputs can result in incorrect or misleading models being presented to clients, leading to unsuitable recommendations and increased risk of poor consumer outcomes.

Examples included:

- **Recognising that models may assume pension access before the minimum pension age.**
- **Identifying reliance on illiquid assets in the cashflow model for lifestyle expenditure.**
- **Considering the impact of taxes on proposed withdrawals, which may necessitate higher withdrawals than projected and potentially exhaust the fund sooner.**

What do you need to consider?

Regularly review cashflow modelling outputs
When reviewing the cash flow modelling output, remember to consider the following:

- Assess how long your clients' funds will last under the base scenario.

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Regularly review cashflow modelling outputs
When reviewing the cash flow modelling output, remember to consider the following:

- Assess how long your clients' funds will last under the base scenario.
- Embrace stress testing scenarios and assess their potential impact on your clients' retirement income compared to their expenditure needs. This comprehensive review ensures that all possible scenarios are considered, providing a solid foundation for their financial planning.
- Evaluate how the cashflow model handles potential tax liabilities, such as income or capital gains tax.
- Check how the software handles cases where your clients' expenditure is expected to increase in certain years, for example, for university funding or specific expenses like mortgage repayment. It would help if you considered whether there are surplus funds to meet such expenses and ensure the model does not presume they can access pensions before the minimum pension age for these expenses.
- Reflect on the benefits of paying more into a pension if affordable, for example, to claim back child benefit, reduce the marginal tax rate, or make early retirement more likely. This strategic move could significantly improve their financial situation.
- Review whether aims such as paying off a mortgage can be met more efficiently by using tax-free cash or income from UFPLS withdrawals.

How can we help your firm address Finding 5?

Our cashflow planning tool, EVPro Goal, delivers a range of functionality to help your advisory firm meet the new FCA requirements for considering better outputs.

Here are just a few of the features available:

- EVPro Goal includes validation to prevent pensions from being accessed before the minimum retirement age and does not rely on property to meet expenses. We also consider the gross amount to be withdrawn to meet a net income requirement.
- You can indicate when a shortfall begins on the charts. Our thorough stress tests assess the financial plan's robustness. We also consider the impact of taxes.
- Create multiple revised plans to compare the impact of changes against the current plan. This can be used to see how shortfalls can be met and to model several different scenarios, including paying off a mortgage early.

Conclusion

When it comes to providing suitable retirement income advice, the FCA’s Retirement Income Advice Thematic Review highlights the importance of adopting robust and realistic cashflow modelling techniques.

The review identified key areas for improvement, such as assessing sustainable income withdrawals, objective-based risk profiling, better customer information gathering, and the need for periodic reviews while keeping your record-keeping up to date.

Effective cashflow modelling is crucial to ensuring clients' financial wellbeing during retirement. The FCA's emphasis on cashflow modelling underlines its critical role in protecting clients' financial futures. Any errors or misconceptions in cashflow modelling can lead to unsuitable advice and significantly harm clients' financial outcomes.

To meet the new requirements and address the FCA's findings, advisory firms must adopt the best practices in cashflow modelling. This involves refining techniques, scrutinising assumptions, stress-testing scenarios, and ensuring clear communication with clients about uncertainties.

Integrating solutions like EVPro into advisory firms provides a wide range of comprehensive functionalities to meet the FCA’s requirements effectively. These tools enable you to offer realistic projections and stress-test various potential scenarios, 1,000 within seconds, to be precise. They also help you communicate consistently with clients, enhancing the quality of retirement income advice and ensuring clients' financial security in their later years.

In conclusion, by adopting realistic cashflow modelling techniques and adhering to best practices, advisory firms can provide personalised recommendations that align with clients' needs and retirement lifestyle aspirations. Cashflow modelling plays an important role in navigating the complexities of retirement income advice, and it's essential to meeting regulatory obligations and, more importantly, ensuring the best financial outcomes for clients in retirement.

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