TURNING CLIENT SUITABILITY ASSESSMENT INTO A SCIENCE

FINANCIAL ADVISORS IN MANY COUNTRIES ARE NOW REQUIRED TO OFFER FINANCIAL PRODUCTS ADAPTED TO THEIR CLIENT'S RISK PROFILE. HOWEVER, MORE THAN 10 YEARS AFTER THE ENACTMENT OF THIS NEW REQUIREMENT, REGULATORS ARE STILL COMPLAINING ABOUT THE LACK OF COMPLIANCE AND SCIENTIFIC VALIDITY OF RISK-PROFILING TOOLS USED TODAY BY FINANCIAL INTERMEDIARIES.

WHY CLIENT RISK-PROFILING?

Following the financial crises in the 2000s, financial regulators strengthened investor protection policies. In particular, regulated firms providing investment advice are now obligated to make suitability checks on behalf of the investor. Financial Advisors should know their clients, and even "have a deep understanding of [their] psychology"[1], in order to recommend them products suitable with their investor profile. In European Union, client suitability assessment is regulated by MiFIDII, coming into force in January 2018.

WHAT DO REGULATORS SAY EXACTLY?

Under the European MiFIDII, investment firms are asked to run suitability tests by checking their client's:
1) Appropriateness: Financial experience and knowledge;
2) Financial situation;
3) Risk profile. Client's risk profile often includes investment objectives, time horizon, risk tolerance and ability to bear losses.

Under the European MiFIDII, the whole client suitability assessment is only compulsory for portfolio management and investment advice. For other investment services, only appropriateness assessment is most of the time required[2]. (DIRECTIVE 2014/65/EU (25)(2)(3)(4)).

In order to ease the implementation of these new requirements, the European Regulator has published additional guidelines and technical advice intended to help with the construction of compliant risk-profiling tools.

Below is a summary of technical advice by ESMA (MiFIDII) in 2014 (ESMA/2014/1569):

1) **Consistency control:** Financial intermediaries should take appropriate steps to control the coherence and consistency of their client's risk profile with other client's information.
2) **Loss aversion assessment.** Putting more weight on the level of loss rather than risk that the client is willing to take.
3) **Recording and updating of client's information at a relevant frequency.**
4) **Simple language**. The investment firm should ensure that questions are likely to be understood by the client.

On top of 2014 technical advice, it is useful to recall some complementary guidelines by ESMA on MiFID in 2012[3]:

1) **Using concrete examples**. For instance,

[1] For Portfolio Manager, Guidelines on certain aspects of the MiFID suitability requirements, Final Report, ESMA, July 2012

2 See 25(4) for exceptions

[3] Guidelines on certain aspects of the MiFID suitability requirements, Final Report, ESMA, July 2012

instead of asking a client whether he feels comfortable with risk-taking, the client can be asked his level of loss over a given period of time he would be willing to accept, either in the individual investment or his portfolio. ESMA gives the following example: " How would you cope with permanently losing 10000 euros on your 50000 euros investments?"

2) **Avoiding the dissimulation of risk-profiling scoring**. Information disclosed to the client should not include the way risk profile is established.
3) **Tailor-made questionnaires.** "When questionnaires are used, they should, when and as they deem appropriate and also to the extent possible in terms of costs, be tailor-made." Esma guidelines, 2012.
4) **Taking demographic data into account,** such as age, marital status, family situation (number of children), employment situation or need for liquidity.

The assessment of suitability is one of the most relevant obligations for investor protection. It applies to the provision of any type of investment advice and portfolio management. In accordance with this obligation, investment firms providing investment advice or portfolio management have to provide suitable personal recommendations to their clients or have to make suitable investment decisions on behalf of their clients. Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. Firms giving investment advice are required to disclose whether they will provide the client with on-going assessment of suitability of the product. Firms providing investment advice must also provide clients with a statement specifying the basis on which the investment recommended is suitable for the client.

MiFIDII Suitability Assessment Presentation by ESMA (https://www.esma.europa.eu/page/MiFID-II-application)

When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, that person's financial situation including his ability to bear losses, and **his investment objectives including his risk tolerance so as to enable the investment firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him and, in particular, are in accordance with his risk tolerance and ability to bear losses.**

MiFIDII 2014, Article 25(2)

HOW ARE CLIENT'S RISK PROFILES ASSESSED TODAY?

To comply with this new regulation, Financial Intermediaries often opt for a paper questionnaire with few explicit questions. 85% of them are

designed in-house[4] and their diversity is huge. In our analysis of 504 of these risk-profiling questionnaires from 50 different countries (52% from European Union), the number of questions varies from 1 to 25. 49% of them evaluated risk tolerance directly with the question: "What is your risk attitude?" or "Which option best describes your risk attitude?". Only 54% took loss aversion into account.

Why are regulators and scholars concerned about risk-profiling today?

> "From a behavioral economics point of view, the field of financial advice is quite strange and not very useful. For the most part, professional financial services rely on clients' answers to two questions: *How much of your current salary will you need in retirement? What is your risk attitude on a seven-point scale?*
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> From my perspective, these are remarkably useless questions."
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> **Dan Ariely, Professor at Duke University**

Over the past decade, many academic and official reports, especially in Europe, have pointed out the lack of compliance and scientific validity of investor-profiling questionnaires.

In an analysis run by UK-FSA in 2011, 54% were judged unsuitable because of their failure to measure risk attitude.

In another report by AMF in 2011, "one third of the audited questionnaires have an overall explanatory power that exceeds 25% (with a maximum of 37.6%), while another third fall short of 10%. (…) Ten of the 14 questionnaires deal with risk-taking preferences but often in a superficial manner. Only 8 questionnaires attempt to quantify preferences regarding risk taking and the questions asked are often too vague to be of any real help for ensuring that clients are sold suitable products."

Similar conclusions have been drawn from studies run by European Member States[5]:

1) The definition of risk is not clearly separated from the notion of loss;
2) Questionnaires do not integrate the basics of psychometrics, econometrics and behavioral economics to properly assess customer risk profile;
3) The scoring method of the questionnaire is often too simple and displayed to the client;
4) Most questions are judged either oversimplified or too technical or ambiguous;
5) There is a huge heterogeneity in the number of questions from one questionnaire to the other;
6) The consistency of answers is not controlled;
7) Firms do not make the effort to gather sufficient information about the client, especially his investment objectives and financial situation (education, profession,…);
8) Firms over-rely on client's self-assessment;
9) Firms attempt to evade their responsibility to give suitable advice by giving the impression that it is the client who decides on the suitability of an investment;
10) Data recording on the suitability process is poor;
11) Firms over-rely on poorly designed risk-profiling and asset-allocation tools.

A few years after the publication of these reports, regulators still have concerns about risk-profiling compliance (FCA, 2014).

[4] Global Private Banking and Wealth Management Survey, PwC, 2014

[5] Evaluation of MiFID questionnaires in France, AMF, 2010.

Assessing investor's risk tolerance through a questionnaire, Consob, 2012.

Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, FSA, 2011.

The high number of unsuitable investment selections we see in the pensions and investment markets is still a significant concern. It is a specific risk to our consumer protection objective (…) The level of failure in this area is unacceptable. We have taken, and continue to take, tough action to address these failings with individual firms.

FSA report 2011

The empirical evidence on the questionnaires used by the Italian investment firms available so far documents several shortcomings (Marinelli and Mazzoli, 2010). In general, the questionnaires are prepared and based on the business model of the investment firms, the characteristics of the products offered and the level of knowledge of the staff involved in the assessment and recommendation process. The main weakness refers to risk tolerance assessment, in most cases elicited only by requesting the risk-return expectations for future investments with respect to hypothetical investment situations.

CONSOB 2012

Questionnaires comply to varying degrees with the recommendations of the various laws and regulations relating to MiFID regarding investment advice: MiFID itself [10, 35], the AMF's briefing paper [3], the Delmas-Marsalet Report [23], CESR guides [8, 9], and the academic literature. Most of the MiFID questionnaires attempt to evaluate risk-taking preferences, but they are not always successful because of the ambiguity of the directive [35] and its implementing decree [10], despite the clarification provided by the AMF's briefing paper [3]. Only one third of the questionnaires try in some way to quantify risk aversion. And yet quantitative measurement of risk-taking preferences is the only reliable way to ensure that suitable products are sold to clients.

AMF 2010

Why does risk-profiling implementation turn out to be so difficult for financial intermediaries?

Following these alarming reports on investor profiling by financial intermediaries, regulators have consulted practitioners to better identify the difficulties of directive implementation[6]. Some factors are listed below:

1) The notion of risk is difficult to apprehend;
2) Clients hold such questionnaires as intrusive, boring and time-consuming;
3) Financial advisers had implemented, in a formal or informal way, such client suitability procedures before and do not understand why they should spend money and time to change them;
4) Responsibilities in product choice based on the answers of the questionnaire are ambiguous;
5) Front Officers are not trained in the basics of psychometrics, econometrics and Behavioral Economics which makes it hard for them to build a compliant and scientific tool;

Investors, and especially retail investors, tend to underestimate the level of risk that they are taking as well as their own risk absorbing capacity. They realize that there is risk in the proposed investment but they might not evaluate correctly the probability of the realisation of the risk in certain circumstances. Risk is an overly abstract concept to govern suitability. Investors might also act in an over confident way by considering that they are better than other investors at assessing risks and will do better. In addition, the investment firm itself, in good faith, might also underestimate the amount of risk which is being incurred by the client.

Esma guidelines 2012

[6] Guidelines on certain aspects of the MiFID suitability requirements, Final Report, ESMA, July 2012

Behavioral Finance as a solution to client suitability assessment burden

Recent reports by both regulators and academic scholars have promoted the use of behavioral finance findings to solve the issue of client suitability assessment for financial intermediaries. Behavioral Finance includes in its models psychological factors which highly impact investment decisions, contrary to what is held by conventional finance. Popularized by Nobel-Prize winners Kahneman and Tversky in the 1970s, behavioral economics have been very successful in the academic world for their application in finance, law and economics. However, behavorial economics have had limited applications in the field of business so far. Reports below highlight the benefits of using these theories to help financial advisors better understand their client's psychology and needs.

> It is clear, therefore, that in the face of such complexity, a wide range of tools is needed to assess risk tolerance. These tools must be able to combine the suggestions from classic economic literature with the indications of behavioural finance and of psychometrics.
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> **CONSOB 2012**

> To explain the steps needed to comply with MiFID requirements, it is helpful to review some of the advances in behavioural finance and experimental economics to explain individual behaviour with regard to financial investments. The findings of academic research, including theoretical analysis, econometric analysis and experimental economics, may help clarify the relevance of the concepts in MiFID and the related laws and regulations. More specifically, the cognitive biases found in decision-making processes under uncertainty are bound to play a major role in understanding and, more importantly, implementing MiFID.
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> **AMF 2010**

Neurodecision: Turning Client suitability into a science

Based on the last advances of behavioral finance, Neurodecision is a user-friendly solution to Client Suitability Assessment burden. Some of the application assets are listed below:

1) **Concrete and simple investment scenarios in plain-English;**
2) **User-friendly interface** which makes suitability assessment entertaining for the client.
3) **Based on the last advances of behavioral finance and machine learning;**
4) **Consistency control of client's answers;**
5) **Loss aversion assessment;**
6) **Complex risk-profiling scoring** which makes the test hard-to-cheat both for the client and the financial advisor;
7) **Adaptive and tailor-made questionnaire** generated by a machine-learning algorithm.
8) **Integration of demographic data,** such as age, marital status, family situation (number of children) or employment situation.
9) **Recording of data through a user-friendly, online and responsive platform.** Both clients and financial advisors have access to their test history on their personal device.
10) **Easy updating of client information.** Financial advisors simply have to send a web link to their clients in order to update theirs risk profiles.
11) **E-Training** to help financial advisors to better understand the psychology of their clients and better address their needs.

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