Thistle Initiatives

Capacity for Loss

The Adviser's Blueprint 05

Best Practice Guides for Retail Advisers

Every firm wants to deliver great advice. But consistency, evidence and oversight can make that harder than it sounds.

With Consumer Duty now firmly embedded and regulatory scrutiny increasing, firms are under growing pressure to evidence the quality and consistency of their advice. The challenge lies in turning those expectations into practical, repeatable processes that work in the real world.

These guides bring clarity to every stage of the advice journey by translating regulation into practical action. We want to help firms move beyond tick box compliance to effective practice, ensuring advice processes are compliant, well governed and truly client centred.

By focusing on what works in practice, The Adviser's Blueprint helps your firm to build stronger frameworks, enhance client trust and stay ahead of regulatory change.

1. What’s the Purpose?

Capacity for loss isn’t a “bolt on” to attitude to risk, it’s an essential, standalone consideration when assessing suitability.

Attitude to risk measures how a client feels about risk — it’s subjective, emotional, and shaped by experience. Capacity for loss, on the other hand, is objective and measurable: it’s about how much risk the client can afford to take without jeopardising two key things:

I. **Their standard of living**: avoiding any material, lasting reduction in their ability to meet essential expenditure.

II. **Their ability to achieve their investment objectives**: ensuring that the level of risk taken is consistent with delivering their agreed goals within the planned timeframe.

This distinction is embedded in ***COBS 9.2.2R***, which requires advisers to have a reasonable basis for believing that any recommended investment is such that the client is able to financially bear any related investment risks consistent with their investment objectives.

In simple terms:

“I’m fine if my portfolio drops 20%” is meaningless unless it’s also true that “If my portfolio drops 20%, I can still meet my goals and maintain my lifestyle.”

If the second statement doesn’t hold, the client is unlikely to have capacity for loss, and the investment strategy must reflect that reality, even if the client’s risk appetite is high.

2. What does Good Look Like?

Breaking it Down — Willing vs Able

- **Willing** = subjective, emotional, based on the client's personal tolerance. Risk profiling questionnaires try to measure this, but it will always be an opinion.
- **Able** = factual, financial, measurable. If the client cannot sustain a fall in value without compromising their essential expenditure, their capacity for loss is low, even if their risk appetite is high.

Good Capacity For Loss evidence is clear, specific, and defensible, which leaves no doubt that the recommendation is both financially sustainable and aligned with the client's risk tolerance and objectives.

I. Facts First, Assumptions Second

Strong capacity for loss assessments starts with hard data. That means verified financial information, up-to-date pension and investment valuations, secure income forecasts, and clear evidence of expenditure. Splitting costs into essential (must be maintained) and discretionary (flexible) is key, and the figures should come from actual spending patterns, not guesswork.

Where assumptions are needed, such as inflation rates or expected changes in expenditure, they must be realistic, explainable, and consistent with firm policy. This ensures your conclusions are grounded in reality, not optimism.

II. Stress Test Like You Mean It

A good assessment doesn't just imagine market falls; it models them in a way that's relevant to the client's portfolio and timeline. Test realistic downside scenarios, for example, a 20% drop with a slow recovery, and show exactly what happens to income, expenditure, and goal achievement.

Stress testing should look beyond the first year. Including prolonged downturns or delayed recoveries give a far clearer picture of resilience, especially for clients relying on withdrawals in the early years of retirement.

III. Link Back to Objectives

Capacity for loss isn't only about protecting day-to-day living standards - it's also about ensuring clients can still achieve their agreed investment objectives. A fall in value might not stop the bills from being paid, but if it derails a retirement plan or delays a major life goal, the strategy still fails the suitability test.

Good practice means explicitly linking your Capacity For Loss conclusion to both lifestyle and objectives. This aligns with COBS 9.2.2R, which requires advisers to confirm the client can bear the risks consistent with their investment objectives.

IV. Make It Clear, Keep It Defensible

A robust Capacity For Loss assessment is only valuable if it's easy to understand and backed up by evidence. File notes and suitability reports should clearly explain the process, the figures used, the scenarios tested, and the reasoning behind the conclusion.

Where possible, state plainly whether the client does or does not have the capacity to take the level of risk being recommended. Labels like "low," "medium," or "high" are open to interpretation and make it harder to explain the practical difference between, say, "medium" and "low" capacity in the client's specific circumstances. A binary statement, supported by documented evidence, removes ambiguity and makes it far easier to justify the recommendation if challenged.

Think of it as answering the FCA's unspoken question: "Can this client really afford this risk?" Your documentation should give a clear yes or no, and show exactly how you know.

3. What Approach Should I Take?

Assessing capacity for loss isn't about following a formula - it's simply about taking a structured, evidence-based approach that blends numbers with context. The aim is to build a clear picture of what, if any, loss a client can genuinely absorb without undermining their lifestyle or their investment objectives. By working methodically from understanding expenditure, through mapping resources, to stress-testing scenarios, advisers can reach conclusions that are both client-friendly and compliant.

I. Start with the Lifestyle Baseline

Begin by identifying the client's "lifestyle floor". This is the minimum level of income they need to maintain their standard of living. You should break this into essential (housing, utilities, healthcare, food) and discretionary (holidays, leisure, gifts) expenditure. Use actual figures wherever possible, drawn from recent bank statements or budgets, so the assessment is grounded in reality rather than rough estimates.

This baseline will serve as the benchmark for judging whether a fall in portfolio value would cause material detriment to the client's lifestyle.

II. Map All Income and Asset Sources

Next, capture a complete picture of the client's resources. Document secure income such as DB pensions and State Pension, then add investment income, savings, rental property, and any other assets that could be used if markets fall.

Don't forget to confirm when each source becomes available, as timing is just as important as the amounts.

Having this full map of resources allows you to identify which needs are guaranteed, which are dependent on investment performance, and where flexibility might exist.

III. Stress Test Against Realistic Scenarios

A good assessment doesn't stop at the baseline assessment. Where possible, it is encouraged that you should model adverse conditions that are relevant to the client's portfolio and timeframe. For example, a 10%, 20%, or 30% fall in value, with at least one slow recovery scenario. In our opinion, this would most easily be achieved through Cash Flow Modelling. (See 'Effective Cash Flow Modelling' for more details.)

Show clients what this actually means in their world. Will they still be able to cover essentials, or would they need to cut discretionary spending? Framing stress tests in terms of real lifestyle adjustments makes the concept meaningful rather than abstract.

IV. Link the Numbers to the Objectives

Capacity for loss isn't just about keeping the lights on - it's about ensuring the client can still meet their agreed goals. A market fall might not stop them paying the bills, but if it delays retirement, prevents planned gifting, or compromises later life care, then capacity for loss is lower than it first appears.

This is where the link to COBS 9.2.2R becomes critical: advisers must be satisfied that the client can financially bear the risks involved, consistent with their investment objectives. Good practice means spelling this out clearly in your rationale.

V. Conclude Clearly, Back it Up

Finally, state your conclusion in plain terms. Does the client have the capacity to take the level of risk being recommended: yes or no? Avoid vague terms like "medium" without context, as these are open to interpretation and difficult to defend.

Back up your conclusion with evidence: the figures used, the assumptions applied, and the stress test results. Clear, auditable reasoning is what transforms an assessment from a subjective view into a robust, compliant piece of advice.

4. How Can I Avoid Common Pitfalls?

Avoid Relying on Optimism rather than Evidence

Advisers sometimes take comfort in assumptions like “the client could just cut back on spending if markets fall.” But have you actually discussed that with the client? Many clients are far less flexible than they think, especially once they’ve retired. What clients say they’ll cut back on, compared against the harsh reality of making cuts if required, often conflict. A couple may say they’re happy to reduce holidays, but in reality, their lifestyle revolves around them. Cutting back could be more disruptive than assumed.

If the flexibility you’re relying on doesn’t really exist, the assessment is flawed. It’s better to ask outright: “If markets dropped 20%, would you be willing to reduce spending, and for how long?” Documenting their answer makes your conclusion defensible.

Don’t forget the Time Horizon

A client with £500,000 invested might look like they have a strong capacity for loss, but context is everything. If they’re 45 and investing for the long term, they can ride out downturns. If they’re 64 and retiring next year, the same portfolio faces immediate withdrawal pressure, and a fall could derail their plan.

Time horizon is often overlooked in Capacity For Loss assessments, yet it’s one of the most important factors. Short-term needs magnify the impact of losses, so advisers must test Capacity For Loss not just against the total pot, but against the timing of withdrawals.

Don’t Ignore the Impact on Objectives

Sometimes an adviser concludes, “The client can cover essentials, so their Capacity For Loss is fine.” But essentials aren’t the whole story. A client may cover bills comfortably, but if a downturn means they can’t retire at 60 as planned, help their children with a house deposit, or fund future care needs, then they don’t truly have the capacity for loss at the agreed risk level.

The FCA expects Capacity For Loss to be linked to objectives as well as standard of living (COBS 9.2.2R). By ignoring objectives, advisers risk recommending investments that technically “work” day to day but fail to deliver on what the client really values.

Avoid vague language

Writing “the client has medium capacity for loss” is ambiguous. This leaves too much room for interpretation. What’s the practical difference between medium and low? And how exactly did you test for it?

Better practice is to state clearly, with evidence, whether the client has the capacity to take the recommended level of risk.

This avoids confusion and makes the conclusion defensible.

5. Our summary

We've explored how to:

- Recognise capacity for loss as a distinct, objective measure alongside attitude to risk, focused on both lifestyle resilience and investment objectives (COBS 9.2.2R).
- Base assessments on verified financial data, using up-to-date valuations, income forecasts, and evidence of actual expenditure.
- Separate essential and discretionary spending to identify the true "lifestyle floor."
- Map all income and asset sources, noting timing and accessibility, not just headline amounts.
- Stress test portfolios against realistic downside scenarios (e.g. 10%, 20%, 30% falls and slow recoveries) and link results to lifestyle impact.
- Check capacity against client objectives, not just day-to-day expenditure, to ensure goals remain achievable under stress.
- State conclusions clearly (client does / does not have capacity) rather than vague "low/medium/high" labels.
- Document the rationale fully, showing data sources, assumptions, and the evidence behind the conclusion.
- Avoid pitfalls such as relying on untested assumptions, overlooking short-term needs, or ignoring objectives.
- Review capacity for loss regularly, recognising that it can change with circumstances, time horizons, or lifestyle shifts.

Good capacity for loss assessment is clear, objective, and evidence-led. It turns vague questionnaire outputs into a defensible analysis of whether a client can sustain losses without undermining their lifestyle or objectives.

6. Our Checklist

Have you...

- ☐ Collected verified financial information?
- ☐ Distinguished clearly between essential and discretionary spending?
- ☐ Stress tested the portfolio against realistic downside scenarios?
- ☐ Considered both lifestyle impact and ability to achieve investment objectives?
- ☐ Reached a clear conclusion?
- ☐ Confirmed capacity for loss will be reviewed as circumstances and time horizons change.

About the Author

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With more than 25 years' experience in financial services, Paul has dedicated his career to promoting compliance and regulatory excellence, helping firms operate securely and with strong governance. His background across retail and corporate advisory environments gives him a deep understanding of diverse financial needs and regulatory challenges.

Specialising in compliance oversight for complex, fast-evolving organisations, Paul develops practical solutions that align regulatory expectations with business objectives. A strong advocate for training and competence development, he helps individuals and teams understand how effective compliance supports sustainable success and long-term growth.