Risk Profiling Approaches Used by Canadian Investment Firms

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ABSTRACT

As a component of a project sponsored by the Ontario Securities Commission (OSC), Investor Advisory Panel, research was completed to review current practices for assessing risk profiles by Canadian firms engaged in the process of delivering investment advice and products to the consumers.

The section of the project focused on current practices was comprised of three components:

- A survey that was provided to mutual fund registered firms, securities licenced firms and portfolio managers to determine their practices as confirmed by their compliance departments.
- A survey to advisors across Canada that determined the advisor view and beliefs about risk tolerance and its assessment.
- An analysis of the risk profiling questionnaires of 36 licenced investment firms operating in Canada from all sectors including bank mutual fund, bank securities, credit unions, independent mutual fund dealers, independent stock brokers, fund manufacturers and portfolio managers. The analysis reviewed the types of questions asked, scoring models used and shortcomings of the questionnaires relative to known best practices in academic literature and regulation globally.

The research found:

- There is a confusing and universal lack of existence or consistency of the definitions of risk concepts and a lack of understanding of the factors involved in risk profiling.
- Almost all regulators surveyed are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of a risk profile. They all recognize and rely on the professional judgment of the advisor and the 'process' created by the advisor or firm to determine a consumer's risk profile. No regulator provides clear guidance on how to combine the multiple factors and form a client risk profile.
- Risk questionnaires are most widely used in retail channels using mutual funds and less so in wealth management and portfolio manager channels.
- Over 53% of respondents to the advisor survey indicated that between 76-100% of their clients had completed a risk questionnaire. Almost half of the

firms reported that risk questionnaires were developed in-house and another 36% said that advisors could choose their own risk profiling methodology. Only 11% of firms could confirm that their questionnaires were 'validated' in some way.
- Most of the questionnaires (83.3%) in use by the industry are not fit for purpose - they have too few questions, poorly worded or confusing questions, arbitrary scoring models, merge multiple factors (75%) without clarity or have outright poor scoring models. Fifty five percent had no mechanism to recognize risk-averse clients that should remain only in cash.

The research was completed in September 2015 and the results of the complete study were made public by the OSC on November 12th 2015 at:

https://www.osc.gov.on.ca/en/Investors_nr_20151112_iap-releases-research-risk-profiling.htm .

See Section 6 of the study for the specific content on current practices in Canada and the results of the 2 surveys and analysis of the 36 risk profiling questionnaires outlined above.