FINANCIAL PLANNING

Financial planning: Taking care of the pennies

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Sean Hilton and Peter Turnbull highlight how using cash-flow modelling can assist separating couples

Stevens & Bolton and RBC Brewin Dolphin

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> ***Cash-flow modelling can help parties to understand what is reasonably achievable from the assets and income available to them.***

The use of cash-flow modelling is becoming ever more common and the trend suggests that it is no longer reserved just for high-value cases. Cash-flow modelling is a tool with significant value (if used correctly) and it is incumbent on the modern practitioner to understand how and when it can best be used.

This article will focus primarily on cash-flow modelling, however it should be noted that the use of such software is just one part of a suite of services that a divorce-focused financial planner ought to be able to offer to solicitors and their clients throughout the separation process.

What is it?

Cash-flow modelling is the process of creating a visual representation of an individual's financial position over the course of their lifetime – charting the money they have coming in, the money going out, how the values of their assets change over their different life stages and so on. Various parameters can be set and a range of scenarios can be considered, including significant life events such as the sale of a property, university fees, gifting to dependants and an exit from a business. For this reason, cash-flow modelling can be considered as a wholly holistic planning exercise that can be tailored to each individual's needs and priorities.

How can cash-flow modelling assist in financial remedy proceedings?

At the outset: managing expectations

Cash-flow modelling can help parties to understand what is reasonably achievable from the assets and income available to them. Splitting marital assets to fund two separate lives may require a reset of expectations. This is potentially very helpful at the early stages of proceedings, helping individuals to focus on tangible goals. There is a fine line to tread, though, with managing expectations and setting expectations. It is all too easy to become fixated on a ‘magic number’ which can, in financial remedy proceedings, be destabilising. Cash-flow modelling should not imbue such fixations; it should help to inform decisions and strategy but should not be the peg on which to hang a hat.

For the solicitor with conduct of a matter, building a team around the client at this stage can help to steer the direction of the case. This is especially true of a client with less financial sophistication, who may not have appreciated the complexities of extricating themselves financially from a relationship, and indeed the reality of having to meet their future needs.

One further benefit to cash-flow modelling, if run early, is helping to complete the income needs section of Form E. An expenditure analysis form for cash-flow modelling should closely match the Form E requirements; ‘two birds, one stone’, perhaps?

During negotiations: considering offers

‘What does this actually mean to me?’ is a difficult question to answer. Blending a range of complex financial structures can be hard to do via an Excel workbook, let alone in the mind. Cash-flow modelling can help to demonstrate whether a proposed combination of tax structures and asset types might be sufficient for your client’s needs.

If a comprehensive baseline model has already been created, simple changes can be made in minutes; this means updating models during, say, a private financial dispute resolution (FDR) hearing is possible.

Cash-flow modelling can also be used to break an impasse in proceedings, demonstrating that an offer should comfortably meet needs. Solicitors will be all too familiar with the client who struggles to accept that a proposed settlement will in fact allow them to maintain their desired lifestyle and in that scenario this tool can help greatly.

As part of a non-court dispute resolution process

Where appropriate, cash-flow modelling can be used jointly by the parties as part of a non-court dispute resolution process. One can see the immeasurable assistance that could be provided to an arbitrator, mediator or private FDR judge in having this tool available as a resource. Clear indications can be given with reference to the direct impact this will have on the short, medium and long-term needs of the parties.

In cases where there is a dispute between the parties on, for example, the required level of maintenance, it is conceivable that a mediator, arbitrator, or private FDR judge would encourage the parties to invest in some cash-flow modelling. Investment returns can then be considered in line with inflation and with foreseeable life events also considered. The financial planner could be engaged on a single joint expert basis, or the parties can seek independent advice.

Post-settlement: transitioning into a new life

A reconciliation exercise post-settlement is a useful thing, accounting for any difference in what has been received versus what was expected. At the time of writing, this is a particularly topical point given the impact of volatile bond yields on defined benefit pension cash equivalent transfer values. Much has been written by pension on divorce experts (PODEs) about this issue.

If the financial planner has been involved from early on in proceedings, they should, by now, have a very good understanding of the client's goals and objectives. The updated model can show how the available assets should be structured to align with objectives, including cash reserves to provide 'breathing space', tax-efficient income strategies, pensions, investments, and protection arrangements. The model should tie all of this together, serving as an 'anchor-point' for the client.

How does it work in practice: engagement process and fact-finding

As has hopefully been demonstrated, there are some potentially substantial benefits to engaging a financial planner at the earliest possible stage in a client's separation journey. Practitioners should be alive to the use of cash-flow modelling from the very first meeting with their client.

Where the client endorses a referral to a financial planner, the solicitor will need to be careful to give the client a list of professionals who may be well suited to assist rather than directing them to a specific individual, as it is good practice to give the client a range of options. It may also be helpful to call the shortlisted financial planners to ascertain their capacity and charging structure. It should be made clear to the client that engaging a financial planner does not mean they are then obliged to use that professional for ongoing financial services.

Financial planners will vary in their engagement process, but the solicitor will be best placed to assist with any file opening requirements having completed this exercise most recently. Some planners will then have their own questionnaire, others will be able to work with an asset schedule prepared by the solicitor or a Form E/exchanged disclosure if the matter has reached that stage.

Undoubtedly, there will be questions the financial planner will need to ask the client that the solicitor may not have explored. For example, what is their appetite for investment risk? Do they have a preference in terms of possible products? What are their medium and long-term aspirations (the solicitor will most likely have focused on the short term)?

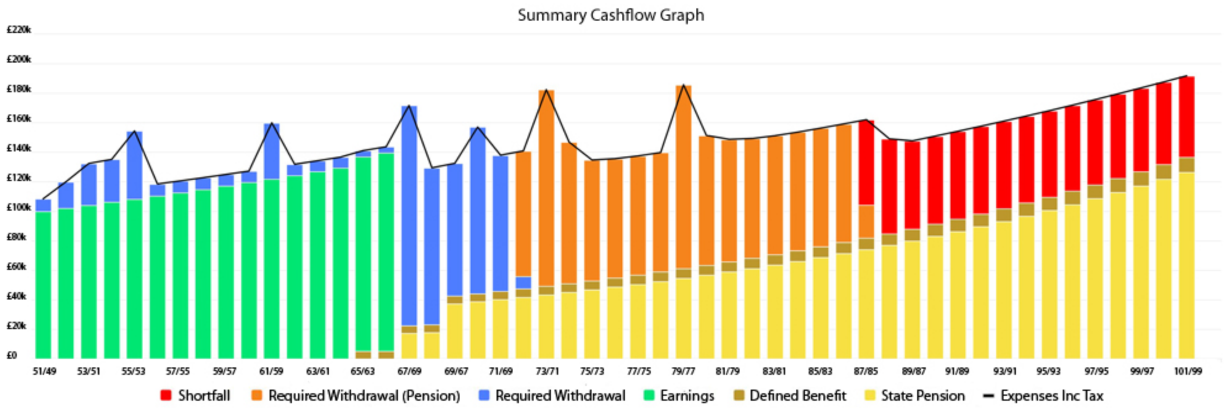
The key to effective working is to mitigate any sense of duplication or additional work for the client. No client wants to spend weeks preparing a Form E only to then complete a lengthy questionnaire for the financial planner which provides the same information. It will ultimately be client money well spent if the solicitor and planner agree how the professional relationship will work as soon as they are engaged. Similarly, there needs to be clarity with the client on how the team will communicate and to whom enquiries should be directed.

In circumstances where a financial planner is being engaged on a joint basis, or as agreed or directed in court or non-court dispute resolution processes, a letter of instruction will need to be considered. An instruction letter which is compliant with Pt 25, Family Procedure Rules 2010 will at times be prudent but, where the process allows, it may be more suitable for a bespoke letter to be sent. The key is to ensure that the remit of the financial planner and their instructions are clear; as discussed below, parallels can be drawn with the use of an actuary or PODE.

How does it work in practice: receiving, reviewing and relying on the cash-flow model

Having ascertained the asset base and clarified the client's key priorities and expectations, the financial planner will produce a cash-flow report which will clearly demonstrate to the client how/if their income needs will be met, and at which point capital will need to be liquidated (most commonly the sale of a property) to meet ongoing needs.

The following chart is provided by RBC Brewin Dolphin, relying on software provided by Intelliflo. The colour-coded bars demonstrate how the client's expenditure is met throughout the course of the plan.



Cash-flow modelling software provides all manner of different 'outputs', ranging from the cash-flow chart shown above through to a breakdown of individual asset valuations throughout the plan and itemised tax liabilities due annually.

The financial planner will decide which combination of the possible outputs is most appropriate and helpful to share with the client and their solicitor, usually presenting these within a written report with some commentary.

Typically, the report is followed by a meeting wherein 'live' changes are made to the model to consider different settlement scenarios.

Interaction with *Duxbury*

The reader may rightly ask: But what about *Duxbury*? The *Duxbury* calculations were designed to calculate the capital sum needed to provide an income for life, adjusted for expected state pensions. Often, we find, this is muddled with general offsetting.

Cash-flow modelling can be used to both capitalise an income stream *and* provide offsetting calculations, relying on similar assumptions to the *Duxbury* calculations, namely:

- the client's age;
- life expectancy;
- income needs; and
- investment return and inflation assumptions.

Importantly, if relevant, cash-flow modelling can make use of various tax wrappers, for instance deploying the capital sum across an individual savings account (ISA), general investment account, and an investment bond (and possibly even other structures still).

The assumptions underlying the *Duxbury* calculations have been questioned, see for example 'Duxbury revisited: is Duxbury a dinosaur?' We do not propose going over old ground, suffice to say, the analysis contained in that article stands.

It seems unlikely that the courts will deviate from *Duxbury*. However, it is incumbent on practitioners to carefully consider whether *Duxbury* is the right 'tool' for the job, depending on case specifics. If used incorrectly, *Duxbury* could significantly favour one party. The informed and cunning practitioner may choose to tilt their allegiances depending on which side they represent, so it is important that all can identify the correct time and place for *Duxbury*.

On the topic of offsetting, it would be remiss not to mention the Galbraith tables released in 2022 for offsetting pension rights. The Galbraith tables are an excellent resource in those cases where pensions need to be addressed and a PODE report is perhaps not needed – referring to the specific guidance at para 6.10 of the 2019 Pension Advisory Group (PAG) report 'A Guide to the Treatment of Pensions on Divorce'.

A word of caution

It is all too easy to paint a rosy picture with cash-flow modelling. The most used profile when modelling is that of steady return, eg assuming that a capital fund will produce a consistent return each year. However, this may be unlikely to materialise in reality. The sequence of investment returns and the impact of pound-cost ravaging can prove fatal, as the following two RBC Brewin Dolphin tables demonstrate:

Table 1: Sequence of investment returns, no withdrawals

No withdrawals

Steady returns					Variable returns			
Year	***Starting capital***	***Growth***	***Final value***		***Year***	***Starting capital***	***Growth***	***Final value***
1	£500,000	5.0%	£525,000		1	£500,000	-12.0%	£440,000
2	£525,000	5.0%	£551,250		2	£440,000	8.0%	£475,200
3	£551,250	5.0%	£578,813		3	£475,200	11.0%	£537,472
4	£578,813	5.0%	£607,753		4	£527,472	13.0%	£596,043
5	£607,753	5.0%	£638,141		5	£596,043	7.1%	£638,141

Table 1 demonstrates that steady returns and variable returns can produce the same outcome *if* income is not being withdrawn.

However, where withdrawals are required, the impact of variable returns can be significant, as demonstrated below.

Table 2: Sequence of investment returns, £50,000 withdrawals

Withdrawals of £50,000 per annum

Steady returns					Variable returns				
Year	***Starting capital***	***Growth***	***Withdrawal***	***Final value***	***Year***	***Starting capital***	***Growth***	***Withdrawal***	***Final value***
1	£500,000	5.0%	-£50,000	£475,000	1	£500,000	-12.0%	-£50,000	£390,000
2	£475,000	5.0%	-£50,000	£448,750	2	£390,000	8.0%	-£50,000	£371,200
3	£448,750	5.0%	-£50,000	£421,188	3	£371,200	11.0%	-£50,000	£362,032
4	£421,188	5.0%	-£50,000	£392,247	4	£362,032	13.0%	-£50,000	£359,096
5	£392,247	5.0%	-£50,000	£361,859	5	£359,096	7.1%	-£50,000	£334,458

Table 2 shows a capital difference of circa £27,400 (approximately 8%!) over five years due to the variable returns. Over a longer timeframe, this disparity can widen even more significantly.

The key reason for the divergence, in this simple example, is the loss of 12% in year one. Losses early in the investment term can have a disproportionate impact on the success or failure of a plan. This is due to the combined forces of sequencing risk and pound-cost ravaging ie being forced to sell investments at a loss to generate income. Setting aside total capital failure, there is only ever an actual financial gain or loss when assets within an investment portfolio are sold and the gain, or loss, is realised. Until that point any valuation is just that – a paper valuation.

It seems likely that the steady return assumption will prevail in financial remedy proceedings. Having seen many joint letters of instructions for pension sharing reports requesting tens of different calculation permutations, it is not too great a leap to imagine an instruction for cash-flow modelling with specified, variable returns over a 30-year period. This would create more arguments/harm than good. For purely pragmatic reasons, a steady return assumption will likely be necessary. However, clients and their solicitors must be aware of the impact that withdrawing funds each year could have on the overall yield and longevity.

Other cautionary notes include:

- A cash-flow model is only ever as useful as the accuracy of the assumptions that it is based upon. It is therefore vital to understand these assumptions and the financial planner should be transparent about the basis of their model. This is also a key point to consider if you are looking to raise questions on cash-flow modelling relied upon by the other party.
- It is not possible to predict the future with 100% accuracy, however every care should go into setting the assumptions used in cash-flow models to try to make them as accurate as possible.
- The assumptions that underpin cash-flow models should be consistently monitored and changes made as and when required. Fluctuations in markets can have a considerable impact on the longer-term plans of the client.
- Cash-flow modelling is not financial advice, so should not be viewed as such. It is intended to act as a guide to help the client better understand their financial future.

Summary

Providing a visual representation of a client's future potential finances through a carefully considered cash-flow modelling process can add value at various points throughout proceedings.

The practitioner should be familiar with several financial advice firms offering services in this space, to provide different options to their clients.

Many financial planners specialising in divorce matters can offer additional services to solicitors and their clients, such as helping to review Forms E, suggesting questions to put to PODEs, attendance at conferences with counsel and helping to establish a new, all-encompassing plan for clients post-completion of a settlement.

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