

Intersection of Risk Management with Goal- directed Personal Financial Planning

INTRODUCTION

According to Financial Planning Association “Financial planning is the process of wisely managing one’s finances to achieve certain goals and dreams, while at the same time helping negotiate the financial barriers that inevitably arise in every stage of life. The financial planning profession exists to help people make those financial decisions and achieve their life goals” Recognizing that business leaders build plans to meet their business objectives, a similar approach can help people in creating a goal-directed and action-oriented financial plan. However, goal setting process itself is fraught with risks which in turn create obstacles in achieving financial goals. Unfortunately, not many people are aware of the real risks related to goal-directed personal financial planning. And very few among them have the ability to identify and effectively manage goal-related risks. In most of the cases risk is managed as an unstructured activity, based on common sense and gut feeling. This often intensifies the impact of unmanaged risk. Pace of change also means that financial goals of an individual or a family change constantly. Therefore management of financial goals-related risks should not be viewed as one time event.

From an applied perspective, a well-constructed personal financial planning process encompasses formulation of financial strategy which in turn prepares people to make sensible decisions by setting financial goals. The advantage of goal-directed financial planning is its correspondence with the way most of the people think about their life. People

ABSTRACT

Personal financial planning is the process of making optimum utilisation of available resources to achieve individual and family goals. Goal-directed personal financial planning helps people in determining where they are financially, where they want to be, and how they can get there. However, people are exposed to wide-ranging risks in the financial goal setting process. These risks in turn have major financial implications on their wealth creation, wealth preservation and wealth distribution aspirations. While existing studies on the subject of personal financial planning focus primarily on insurance and investment related risks, there is not much literature available that explicitly addresses the issue of aligning risk management framework to the goal-directed personal financial planning. This conceptual paper attempts to critically examine the risks related to setting personal financial goals and suggest ways of treating identified risks to attain lifetime financial freedom. The paper also aims to provide academicians and planners in the financial services industry with an outline of the key issues to consider as they develop understanding of the risks associated with goal directed financial planning.

have certain goals they wish to accomplish: buy a home, buy a car, holidaying at an exotic location, grand marriage and higher education of children from a prestigious college etc. It is for this purpose that people need to plan their finances to achieve those goal, and failure to reach them results in lower utility. Thus, goal-directed financial planning is simply a practical way to process the available information in maximizing expected utility. However, the most pertinent questions people ask are (a) What types of risks they may encounter in goal-directed personal financial planning, and (b) Steps they should initiate to identify, evaluate, prioritize and treat identified risks? The existing literature addressing these questions has been reviewed in the later section of this paper.

In summary, comprehensive personal financial planning is the process of formulating, implementing, and monitoring multifunctional decisions that enable people to achieve future financial goals. The future, as we all know, is deeply unpredictable and exposes people to risks. Risks across the goal-directed personal financial planning in turn may pose obstacles in accomplishing future financial goals. Therefore, creating awareness about risks associated with goal-directed personal financial planning and preparing people to manage identified risks can place them in a relatively secure position financially.

It is in the above background that this paper explores the extent to which aligning risk management framework to goal-directed personal financial planning can support people in making intelligent financial decisions for seeking lifetime financial freedom. Paper is also expected to help academicians and planners in the financial services industry with an outline of the key issues to consider as they develop understanding of the risks associated with goal-directed financial planning

The Remainder of this paper proceeds as follows. Section 2 presents literature review on goal-directed personal financial planning and risk management. Section 3 focuses on establishing

linkage between risk management and goal-directed personal financial planning. Section 4, comprehensively describes risks relating to personal financial goals using examples and recommend risk responses for treating identified risks. Finally, section 5 presents summary and conclusion.

Goal-directed financial planning and risk management: A literature review

Setting financial goals helps to direct financial planning. Goal setting is done with an objective to meet certain financial requirements such as buying a home, saving for child's higher education, provision for financial independence in retirement, etc. A concept of goal (or aim, motive, purpose, etc.) has been long taken for granted in many accounts of human behaviour. Goals modify behaviour; ambitious goals lead to greater and more prolonged effort (Locke and Latham 2002). People traditionally associate risk management to investment and insurable risks. However, this traditional approach to risk management is changing progressively as it falls short of providing the sense of security people seek through personal financial planning. Personal financial planning is broadly defined as a process of determining an individual's financial goals, purposes in life and life's priorities, and after considering his resources, risk profile and current life style, to detail a balanced and realistic plan to meet those goals. The individual's goals are used as guideposts to map a course of action on what needs to be done to reach those goals.

The Certified Financial Planner Boards of Standard, Inc. in the United States provides a broad definition of financial planning. This definition explains financial planning as "the process of meeting your life goals through the proper management of your finances. Life goals can include buying a home, saving for your child's education or planning for retirement."

A more comprehensive definition is provided by Warschauer (2001, cited in Warschauer, 2002) as follows:

"Financial Planning is the process that takes into account the client's personality, financial status and the socio-economic and legal environments and leads to the adoption of strategies and use of financial tools that are expected to aid in achieving the client's financial goals."

This definition by Warschauer suggests that not only do financial planners need to possess technical skills but also require relational and strategic skills. Further, it needs to be recognised that individuals and their financial advisors cannot predict the future accurately. For this reason a more comprehensive view of risk management with reference to goal-directed personal financial planning is necessary. In generic terms, risk is a function of two factors - uncertainty of the outcome, and significance of the consequences. The former is generally lowered by acquiring more information, while the later is addressed by reducing one's stakes (Taylor, 1974). From applied perspective, individuals and families seek to lower uncertainty by attempting to learn more about risks across financial planning cycle. Risk management is defined as the "identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or maximize the realisation of opportunities" (Hubbard, 2009). ISO 31000 defines risk management process as "systemic application of management policies, procedures and practices to the tasks of communication, consultation, establishing the context, identifying, analysing, evaluating, treating, monitoring and reviewing risk."

In fact, to the extent organizations are collections of individuals, risk management essentially begins at the personal level, and is adapted to the level of organisations (Culp, 2001). Thus, it seems relatively straightforward to adapt and align the basic concept and strategies of (organizational) risk management to the goal-directed personal financial planning.

One quick inference that stems from preliminary discussion in this para is that the study of risk and risk management is relevant in the context of goal-directed financial planning and application of risk management helps in the discovery and treatment of goal related risks. With a broad understanding of goal-directed financial planning and risk management, the aim in the following section is to establish link between risk management and goal-directed personal financial planning.

Establishing linkage between risk management and goal-directed personal financial planning

Risk management in the context of goal-directed financial planning is the systematic approach to the discovery and treatment of risk. It is a thinking process requiring imagination and ingenuity. It generates a realistic attitude among people by preparing them to identify, evaluate, prioritize and manage risks rather than being taken by surprise when they arrive. The objective is to minimize worry by dealing with the possible financial losses before they materialize. Both risk management and goal-directed financial planning involve processes that amalgamate with wealth accumulation, wealth protection and wealth distribution goals of individuals and families. Both have upside (opportunity driven-value creation potential) and downside (value destruction potential). Thus, risk-return trade off, which is fundamental aspect of risk management, can effectively be applied to goal-directed financial planning as well. Both require extensive planning to predict the desired outcome. Uncertainty is an inherent element in both the disciplines.

In fact, risk management strategy and goal-directed personal financial planning are intimately associated. In a nutshell, risk management and goal-directed financial planning deals with future events (set in a context) whose outcome (positive, negative or neutral) is not precisely known and provides opportunity for financial freedom. Financial freedom

that people aim at throughout their lives is dependent upon achievement of financial goals. Achievement of financial goals thus is logically driven by integration of risk management framework to goal-directed personal financial planning. This can be done by striking a careful balance between risk management and goal-directed financial planning. Personal financial strategy helps in creating synergies between different risk management activities of households and in turn prepares them to make prudent financial decisions. Financial strategy also helps in drawing clear, precise and definite financial goals and creation of sustainable personal wealth similar to value creation in an organizational context. Meulbroek (2002) identifies that the goal of risk management

is to “maximise shareholder value” which is compatible with the goal of “optimisation of personal wealth”. But goal setting itself is extremely challenging and fraught with risks.

Process of integrating risk management to personal financial planning cycle begins with creation of an individual or a family risk management policy. A solid risk management policy contains the purpose, principle and procedure for implementation. The purpose of a family risk management policy may be to reduce risk for family members, both individually and as a whole. Adherence to the policy would go far to protect the family’s human and financial assets and minimize potential liability (Annino, 2012). Table I below provides an integrated view of risk management and family risk management.

Table I

A Continuous Risk Management Process	Family Risk Management: A Six-Step Process
<pre> graph TD A[SET STRATEGY/OBJECTIVES] --> B[IDENTIFY RISKS] B --> C[ASSESS RISKS] C --> D[TREAT RISKS] D --> E[CONTROL RISKS] E --> F[COMMUNICATE & MONITOR] F --> A </pre>	<ol style="list-style-type: none"> 1. Define long-term Family goals and objectives 2. Identify risks associated with family objectives 3. Prioritize risks by likelihood of occurrence and potential impact 4. Create mitigation strategies for Top-priority risks 5. Commit resources For implementing Mitigation strategies 6. Monitoring the risk Landscape and results of mitigation efforts
Adapted from ICAEW, London, U.K., 1999	Adapted from Abbot Downing (2012)

At the first glance, goal-directed personal financial planning and risk management process appears unconnected. However it can be observed that there are indeed striking similarities among the components of continuous risk management process and family risk management process depicted above. Both begin with set strategy/objectives corresponding to define long-term family goals and objectives. Communicate and monitor is the same as monitoring the risk landscape

and results of mitigation efforts. Thus, aligning risk management process, encompassing set strategy/objectives, identify risks, assess risks, treat risks, control risks and communicate and monitor, to goal-directed personal financial planning appears logical.

Having established the linkage between risk management and goal-directed personal financial planning, in the following section paper describes goals related risks and ways of treating the identified risks.

Financial planning goals related risks

Financial goals are specific objectives to be accomplished through goal-directed financial planning. Setting goals is thus fundamental to attain financial success. Goals reflect the personal values people attach to wealth. Advantage of goal-directed planning is its correspondence with the way people think about their lives. People have certain goals they

want to reach: education, buy a house, buy a car, etc. They need to plan their finances to accomplish those goals, and failure to reach them results in lower utility. Thus, goal directed planning is simply practical way to process the information available in maximizing expected utility (Robinson, 2000). However, goal setting process itself is open to various risks. Table II below list out the goals related risks.

Table II: Financial planning goals related risks

Risk drivers	Associated risks
Failure to understand big picture- unrealistic goals Setting multiple goals Failure to involve spouse in goal setting Fixing higher aspiration base Failure to review goals	Goal ambiguity risk Goal conflict risk Goal prioritization risk goal sequencing risk Goal implementation risk Aspiration base risk Outdated/ obsolete goals risk

Risk Treatment

Know thy self and know your financial goals. To avoid goal ambiguity, expert panel at Abbot Downing, believe that the fundamental question to be considered is, "what do you want to accomplish with your wealth?" According to them, the answering to this question will become a part of the family's collective voice. Findings of "Shared Goals and Values Scale" developed by Archuleta (2008) also explain that couples with higher scores reflect more in agreement on

life goals than those with lower scores. Thus collective approach to setting goals can help in clearly articulating the goal statements and vision, sub-goals and milestones, action plans and priorities. Meyer (2003) describes the characteristics of SMART goals in attitude is everything. Use of goal setting worksheet in the SMART format (Table III) helps in objectively defining the goals. Objectively defined goals are not only achievable but also help in reducing aspiration base risk.

Table III: An Example of SMART financial Goal

Acronym "SMART" stands for Specific-Measurable-Attainable-Realistic-Time bound	
Smart Goal: Accumulating margin money to avail home loan for acquiring residential property	
S	I would like to save money for buying a three BHK
M	I would like to save Rs 600000 as margin money
A	I will save Rs10000 (PMT-Rs.7895.79 @9% pa) a month from job until next five years.
R	Same as above
T	I will have all of the money by month/year
Specific - SMART Goals are specific enough to suggest action. Example: Save enough money to accumulating margin money to avail home loan for acquiring residential property, not just save money.	
Measurable - You need to know when you have achieved your goal, or how close you are. Example: A car costs Rs 6 lakh, and you have Rs 3 lakh already saved. Goals which aren't measurable, like "I'd like to have more money," are much harder to achieve and you don't even know when you get there!	
Attainable - The steps toward reaching your goal need to be reasonable and possible. Example: I know I can save enough money each month to arrive at my goal within one year.	
Relevant- The goal needs to make common sense. You don't want to struggle or work toward a goal that doesn't fit your need. Example: You don't need to save money for 18 pairs of shoes.	
Time bound -Set a definite target date. Example: The repairman says my refrigerator won't last another year	

Stawski et.al (2007), examined the extent to which goal clarity and financial planning activities predict retirement savings practices. Their findings provide support for the model in which retirement goal clarity is a significant predictor of planning practices, and planning, in turn, predicts savings tendencies.

Family members usually have conflicting needs and wants. Multiplicity of goals setting without prioritizing goals creates barriers in accomplishing goals. Therefore, making goal setting a family affair is commonsensical. When everyone is on-board it is easier to commit to goals. Ideally, aligning risk management to goal-directed financial planning involves laying the goal setting process whereby the utmost importance is assigned to high priority goals and goals with lower priority are handled in descending order. People live in a dynamic environment and hence monitoring and reviewing goals provide consistent results commensurate with changes in financial status. Setting priorities, sequencing sub-goals that lead to attainment of primary goals, and working diligently towards them in a time bound manner, reviewing and reworking priorities and goals help in mitigating goal-related risks and make the financial planning exercise more fulfilling.

Summary and Conclusion

Key findings suggest that risk is an interesting topic in the context of goal-directed personal financial planning. It reinforces concerns that people may not understand the extent and/or nature of risks or they may underestimate risks. Paper also highlights that risk is not a bad thing, just as long as it is monitored, reviewed and rebalanced from time to time. Paper indicates that people hardly take genuine view on risks concerning goal-directed financial planning. Study suggests that risk management can be fairly useless if the process is not integrated with goal-directed financial planning. Study shows that by carefully identifying, evaluating, prioritizing and treating risks, people are better

prepared to deal with unpredictable scenarios that can wreak havoc with their personal wealth. Setting up the right risk management framework can also facilitate the most effective utilisation of financial resources. In conclusion, this paper outlines conceptual framework for aligning risk management to goal-directed personal financial planning for attaining lifetime financial freedom.

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