BMO Wealth Institute™

/Report
CANADIAN EDITION

Financial decision-making: Who will manage your money when you can't?

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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Executive summary

Canadians approaching retirement have a lot to think about. One of their main preoccupations is preparing for a comfortable retirement without financial worries. Many of us realize that it is up to us to make that happen. We know we will have to rely on our accumulated financial resources as we get older.

What we often forget, however, is that our financial success depends heavily on our ability to make the right financial decisions. Financial decision-making is a complex activity that requires a high degree of mental capacity — higher than most people think. It is also an activity that is particularly vulnerable to the kind of cognitive loss that is a common by-product of advancing age.

As life expectancy rises, more and more Canadian baby boomers will reach the life stage at which cognitive ability declines. This will, in turn, affect their financial capacity and the quality of their financial decisions. Regrettably, this will also coincide with the life stage at which they can least afford to make financial mistakes: there is more at stake, as their financial wealth is likely at its peak and they are most dependent on their financial assets.

For this reason, Canadians should not overlook the need to ensure proper delegation of their financial affairs in the event of the loss of their financial capacity. Not planning for this contingency can have potentially disastrous financial implications — maybe even more so than ignoring the risks of outliving their assets, inflation and escalating health costs.

Most Canadians are now aware of the need to engage in estate planning to ensure the smooth transition of their assets when they are no longer around; it is time they also made advance planning for potential financial incapacity an indispensable part of their overall financial plan.

Introduction

Canada's population is aging rapidly. Today, fewer than five million Canadians are 65 or older. That number is expected to more than double in the next 25 years. By Statistics Canada's estimate, there will be 9.9 million to 10.9 million seniors in Canada by 2036, and at some point over the next 10 years, the number of Canadian seniors will exceed the number of children aged 14 or under for the first time.[1] Many have written about the impact of this demographic shift on Canadian society. The anticipated strain on government programs such as health care and public pension plans has been well documented. For baby boomers entering retirement, these changing realities will have an impact on their plans to provide a sustainable retirement income stream, and have therefore become a regular topic of discussion.[2]

Less frequently considered, though, is another consequence of aging: cognitive changes that may adversely affect one's ability to make sound financial decisions. The result of not addressing this risk can be severe. For baby boomers, who hold the bulk of household wealth and who will be depending on that wealth for their financial well-being during retirement, failure to address this risk can be more devastating than the more frequently cited risks of outliving one's assets, inflation or escalating health care costs.

In this report, the goal of the BMO Wealth Institute is to raise awareness of the potential impact of incapacity and the importance of making plans before it is too late.

Older and wiser?

For the current cohort of baby boomers, the mantra is, "Sixty is the new forty." To them, the notion of diminishing mental capacity may seem remote. Some may even be offended by the suggestion that aging and cognitive decline can go hand in hand.

But this may be due to a lack of understanding that mental capacity is decision-specific. In other words, whether a person has "capacity" depends on the type of decision being made. For instance, the law sets a fairly low standard for personal decisions such as getting married, but a much more stringent standard is imposed when it comes to making a will. Interestingly, this means that you may have sufficient capacity to get married, but not to execute a will — yet the act of getting married may have an impact on your will, since in many jurisdictions, marriage results in the revocation of an existing will. A marriage late in life, in particular, could result in a drastic, and perhaps unintended, change in your estate planning. Already there have been numerous court cases involving late-life marriages that had the inadvertent consequences of revoking long-standing wills, and we can expect to see more of them as the Canadian population gets older.

When it comes to handling financial matters, financial capacity has been found to be an "advanced" activity of daily life, and it represents a cognitively complex activity that may be particularly vulnerable to dementia and cognitive aging.[3] If so, it is only reasonable to anticipate that as one ages, one's financial capacity will gradually deteriorate.

This, however, is by no means a generally held belief. In a recent survey of Canadians 45 years and older commissioned by the Institute,[4] almost 70% of the respondents expressed the opinion that a person's investment knowledge increases with age, and 57% opined that a person's investment skill increases with age. Many would also point out that some of the world's most renowned investors are seniors, and the most successful of them — Warren Buffett — has already celebrated his 80th birthday. The investment success of these veteran investors is often attributed to their depth of investment knowledge, experience and awareness of the fundamental principles of investing (such as diversification, risk avoidance, etc.), all accumulated precisely because they have had longer to do so. And yet there is now increasing evidence that greater knowledge of the principles of investing does not necessarily translate into better investment performance. Several studies have shown that as one ages, one's declining cognitive abilities hinder the effective application of those principles.[5]

Nor does it help that financial literacy among adult Canadians is low to begin with. The Task Force on Financial Literacy reported recently that 49.8% of adult Canadians struggle with simple tasks involving math and numbers.[6] Seniors in particular are found to have difficulty, whether trying to keep track of their finances, choosing financial products or simply planning ahead.[7] If these findings are any indication, financial capability has not been found to improve with age.

The elephant in the room: Alzheimer's disease and dementia

Then there is the worst-case scenario: loss of mental capacity brought on by Alzheimer's disease and other forms of dementia. Awareness of these ailments has grown in recent years, partly as a result of some high-profile patients (such as former U.S. president Ronald Reagan), and partly due to more and more personal encounters with the disease.

While dementia is not a normal part of aging, aging is certainly one of its major risk factors. The likelihood of developing dementia doubles with every five years of age after age 60.[8] According to the Alzheimer Society of Canada, age is the most important risk factor when it comes to Alzheimer Disease; furthermore, many of the other known risk factors for the disease tend to increase with age (such as elevated cholesterol and being overweight). The Alzheimer Society of Canada also states that the older you become, the higher the risk: one in 20 Canadians over age 65 and one in four of those over age 85 are affected by Alzheimer's disease.[9] Currently, more than 500,000 Canadians are living with Alzheimer's disease or a related dementia. The Alzheimer Society projects that by 2038, the number of Canadians living with dementia will more than double, to 1,125,000.[10]

Dr. Michael Baker, a practising physician and professor of medicine at the University of Toronto, states that, "Although we may have some mild memory loss with age, it tends to be stable and not associated with the many other symptoms of dementia. Alzheimer's disease, on the other hand, is ultimately associated with language difficulties, disorientation, inability to follow instructions and often inappropriate anger or tears. Dementia that results from a stroke can have a sudden onset with loss of several mental functions at the same time." The erosion of memory, language and judgment abilities that comes with dementia translates directly into loss of capacity to manage financial affairs. And it can strike quickly. Recent research has shown that patients with mild dementia experience a dramatic decline in their ability to make financial decisions over just a one-year period.[11] These patients have been found to have difficulties paying bills, balancing cheque books and understanding bank statements — all financial tasks that are often considered to be relatively simple.[12]

The likelihood of developing dementia doubles with every five years of age after age 60.

By 2038, the number of Canadians living with dementia will more than double, to 1,125,000.

A related problem is the financial exploitation of elderly people, the most prevalent form of elder abuse in Canada. Older adults are more susceptible to financial abuse, as their ability to recognize telephone or mail fraud diminishes. Dementia only makes it worse. Cases of financial abuse are reported regularly in the media; many involve professional scam artists, and others involve family members and relatives who decide to take advantage of their own kin. Stories also abound about "new best friends" (referring to a common technique used by fraudsters who befriend older adults and then isolate them from their network of friends and family in order to gain control over their finances) and fraudsters who pose as "grandchildren" who "are in trouble and need money."[13]

Plan now — It's later than you think

As life expectancy rises, more and more of us are likely to reach the life stage at which diminishing cognitive ability will adversely affect the quality of our financial decision-making. Accordingly, just as we engage in estate planning to ensure the smooth transition of our assets to our heirs when we are no longer around, we should also plan for potential incapacity, to ensure proper delegation of our financial affairs in the event that we lose our financial decision-making power.

According to the Institute's survey, 76% of respondents are aware of the need for a continuing power of attorney (CPOA), but only 59% have actually put one in place. As one might expect, awareness of the importance of a CPOA, as well as the incidence of having one, increases whenever respondents have had real-life experiences with the issue. One may have this "eye-opening" experience after witnessing a family member suffer from a decline in the ability to make sound financial judgments, or after taking over the affairs of a family member, friend or colleague suffering from a loss of mental capacity.

41%

of the survey respondents do not have a CPOA, and, more than half (54%) of these respondents say, "I don't think I need one yet."

Continuing power of attorney

A power of attorney is a legal document by which the **grantor** (i.e. the person granting the power) appoints one person or more to act as his or her "**attorney**" in all matters related to his or her financial affairs and assets. A **continuing power of attorney (CPOA)** is a power of attorney that remains in place even if the grantor becomes incapacitated. Terminologies used to describe this document vary from jurisdiction to jurisdiction. In Quebec, such a document is referred to as a "mandate"; in other provinces, the term "enduring power of attorney" is used, while in the United States, it may be referred to as a "durable power of attorney."

A CPOA can become operational immediately after it is executed. However, when incapacity planning is the main objective, the springing form is typically used. With the springing form of CPOA, the power remains dormant and will not take effect until some point in the future when it is triggered by a designated event. A common trigger, for example, is medical certification that the grantor is no longer capable of managing his or her own affairs.

The Institute found that 41% of the survey respondents do not have a CPOA, and, more than half (54%) of these respondents say, "I don't think I need one yet." Other reasons identified for not having a CPOA are lack of time, not knowing how to begin, not wanting to lose control over financial decisions, fear of misuse of power by the attorney, procrastination and, finally, a sheer lack of desire to think about incapacity.

It is also interesting that more than half of those currently without a CPOA expressed an intention to have one prepared in the future. People seem to realize that they will eventually need to plan for incapacity — but just not now.

People have a tendency to put off their planning to a future date because they don't fully appreciate the consequences of not acting. The Institute's survey revealed that more than one in five respondents thought that even after being found incapable of making financial decisions, they would still have the power to execute a CPOA, put a bank account into joint names with a child, make a new will or modify an existing will. Also, 17% were of the opinion that they would still be permitted to change an RRSP/RRIF or insurance beneficiary and revoke an existing will, and 13% thought they would still be able to give investment instructions to their financial advisor. The truth is that once a person is deemed to have lost capacity — and absent a validly prepared CPOA — the only recourse is to have a court-appointed guardian manage that person's affairs, a result that few people would have intended or would relish. Elena Hoffstein, a lawyer who specializes in estate planning and charity law, and a partner at Fasken Martineau DuMoulin LLP, states, "It is extremely important for a person to plan for possible incapacity, because once incapacity hits, he or she will not be able to make any decisions related to his or her financial situation, whether it be creating a continuing power of attorney with desired wishes, or changing or revoking an existing continuing power of attorney."

Once you are found incapable, you will NOT be able to:

- prepare a power of attorney
- make a new will, add a codicil to an existing will or revoke an existing will
- put a bank account into joint names with children
- change the beneficiary of your RRSP/RRIF or an insurance policy that you own
- carry out estate planning, such as reducing probate costs
- give investment instructions to your financial advisor.

Some people may also think that they will be able to detect the early onset of cognitive decline and start planning at that point. This is not advisable. Planning should be done when you are in full command of your faculties. Once one's capacity is in decline, the issue of whether one has the required capacity to engage in planning becomes problematic. According to Hoffstein, "There is a general lack of knowledge in knowing when or how incapacity will strike. People need to be prepared and ensure their affairs are in order while they are still fully mentally capable." Aside from that fact, one should also realize that the effects of reduced critical thinking skills that come with age often creep up on you, and may not be obvious in the early stages. A person may be perfectly able to conduct a social conversation and act normally in a social context, yet already be suffering from diminishing capability to deal with financial matters. Dr. Baker confirms this: "Dementia can have an insidious onset, which means that a person can still function in some ways, while being deficient in other ways. For example, a person with early Alzheimer's disease could still do gardening or household chores, but may be unable to understand complex instructions or even balance a cheque book."

Individuals who lack medical training are not equipped to spot the early signs of diminished capacity. If noticed at all, an aging person's reduced speed of processing information and inability to focus attention are often explained away by other changes that come with age, such as vision loss and hearing loss, which are unrelated to cognitive decline. In this way, aging persons suffering from cognitive decline may continue to make financial decisions — decisions that are far from optimal and that can potentially cause irreversible harm to their financial health. For investors who routinely take care of their own investments, the need to plan in advance for potential incapacity is an even greater priority. Since most self-directed accounts are managed over the telephone or over the Internet, these investors rarely have regular contact with financial professionals, who may be the first to recognize a client's diminishing financial capacity.

Rarely do people enjoy thinking about their own possible loss of mental capacity, which may explain the psychological resistance to planning for this contingency. Surely, however, the thought of death is equally unpalatable — yet, according to the Institute's survey, virtually all the respondents (98%) were aware that they needed a will, and nearly nine in 10 (86%) already had a will in place. It is true that loss of mental capacity is not as absolute a certainty as death, but considering the elevated risk as one ages, and the potentially disastrous financial implications of not planning, it is time Canadians made planning for potential incapacity an indispensable part of their overall financial plan.

Do I really need a CPOA?

In the Institute's survey, one-third of the respondents expressed concerns about the possibility of a decline in their own ability to make sound financial decisions in the future. Of these respondents, two-thirds (67%) revealed that their solution was a popular homemade solution: holding assets in joint names with a spouse or partner or with children. By comparison, only 58% had opted for a CPOA.

Joint ownership is not necessarily an adequate incapacity planning tool.

Joint ownership is not necessarily an adequate incapacity planning tool. In fact, the use of joint tenancy is most often motivated by a desire for convenience, as well as the desire to simplify estate administration and minimize probate fees in the future (especially in provinces where probate fees are relatively high). Joint owners are often spouses, but an older person — perhaps widowed — may also hold assets in joint names with adult children. The numerous potential pitfalls of holding assets in joint names with a child have been pointed out repeatedly. In adding a new joint owner, one is inevitably exposed to potential theft or misuse of the financial asset by the new joint owner, or to the claims of the new joint owner's creditors. Where the new joint owner is one of several children, it may result in acrimony, dissension and, ultimately, litigation among the children.[14] As a lawyer dealing with such issues in her practice, Hoffstein stresses, "It may not be the right strategy to put assets in joint ownership. Today many families are blended families, and it may not be appropriate to leave everything outright to the surviving spouse through joint ownership. It may be more appropriate to leave your estate in trust for a surviving spouse, so that your will guarantees that on the death of that surviving spouse, your estate goes to your own children rather than the children of your spouse. There are other ways to plan for incapacity, such as a CPOA."

The CPOA is tailor-made to deal with incapacity issues, since its directions, thought out and set out in advance, remain in force after the grantor is found to be incapable. For this same reason — because it authorizes another person to act on behalf of the grantor when he or she is no longer able to do so — it is a document that should be executed only after very careful deliberation.

The most critical decision relates to the choice of the attorney(s). An attorney has onerous duties to carry out, and the duration of such responsibilities can be lengthy. For instance, the respondents in the Institute's survey with experience as an attorney under a CPOA reported having performed those duties, on average, for about four years. It is important to ensure that the person or persons being appointed will have the time and willingness to fulfill the responsibilities.

It is equally important that you appoint someone in whom you have complete trust. In fulfilling his or her duty, an attorney is required to conduct financial transactions in the best interests of the grantor; however, the sweeping nature of most powers of attorney create immense potential for misuse, both innocent and intentional. An attorney who is not financially savvy or fully aware of his or her obligations may make imprudent decisions, while an ill-intentioned attorney may seize the opportunity to exploit the now-incapable grantor. Thus, while the CPOA is a useful tool for advance planning, there is an increased risk of abuse when the grantor is a vulnerable individual or incapable.

A further issue is family dynamics. If you have a number of children, but appoint only one of them as your attorney, tension may result among your children. On the other hand, appointing more than one attorney may complicate the decision-making process.

While for many the CPOA is an appropriate tool in planning for incapacity, it is by no means the only one. For those with larger asset bases and more complex needs, there are other sophisticated incapacity planning strategies that involve the use of trusts, such as alter ego and joint partner trusts. Still others may simply wish to put their investments on "autopilot" after reaching a certain age. For them, the use of discretionary investment accounts, life-stage funds and guaranteed life income products may be worth considering.

The choice of tool will vary according to one's situation, but one thing remains the same: the need to plan and take action. Everyone needs to plan ahead for potential incapacity. As with so many other things in life, we can hope for the best, but always need to plan for the worst.

Conclusion

Aging is a process that is often accompanied by a decline in cognitive ability. Financial decision-making is a complex activity that requires a relatively high level of mental capacity. It is an activity that people of all ages find challenging enough; declining cognitive abilities will only make it even more difficult.

Dementia — an ailment characterized by progressive deterioration of thinking ability — affects the aging population disproportionately. Even mild dementia has been found to dramatically reduce a person's ability to handle financial activities that may otherwise be deemed simple.

As we live longer and depend more and more on our own resources for our financial well-being, prudent management of the risks in retirement income planning is essential. Much has been said about investment risk, inflation risk, longevity risk and health care risk. Less commonly discussed is the risk of financial mismanagement as a result of cognitive decline in later life, whether as a result of normal aging or the onset of dementia, but this risk is certainly no less significant. The stakes are high too; at around age 60, just when the likelihood of developing dementia soars dramatically, a person's net worth is also most likely to have reached its pinnacle.

Canadians should therefore plan ahead to ensure that their financial matters will continue to be properly handled in the event of the loss or decline of their financial capacity. They should make those plans early, well in advance of any possible decline in financial decision-making capability, because the opportunity to plan may be lost once there is doubt as to whether one is still in full command of one's faculties. Rather than making incapacity planning a future "to do," Canadians should ensure that it is an integral part of their comprehensive financial planning and deal with it now.

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1 *Population projections: Canada, the provinces and territories 2009 to 2036,* Statistics Canada.
2 See, for example, the recent BMO Retirement Institute report *Retirement Income Planning: Can we have our cake and eat it too?* (February 2011).
3 *Assessing financial capacity in patients with Alzheimer disease* (2000), Marson, Sawrie, Snyder et al.
4 Leger Marketing survey (May 27, 2011) conducted for BMO Wealth Institute.
5 A 2007 study, *Do older investors make better investment decisions?*, Korniotis and Kumar (2007), found that older investors exhibit lower stock selection and diversification skills. Another 2010 research study, *Older and wiser? An affective science perspective on age-related challenges in financial decision-making,* Weierich, Kensinger, Munnell, Sass, Dickerson, Wright and Barrett (2010), suggested that financial decision-making in older adults might not be as rational and forward-looking as it needs to be, which is bad news for a generation of retirees and near-retirees who know they will need to rely heavily on those abilities in retirement. Still another study, *The age of reason: Financial decisions over the life-cycle with implications for regulation,* Agarwal, Driscoll, Gabaix and Laibson (October 19, 2009), measured 10 types of credit behaviour and concluded that the ability to make sound financial decisions peaks when people are in their 50s, and then falls sharply as they enter their 70s and 80s.
6 *Canadians and Their Money*, Task Force on Financial Literacy (December 2010), page 17.
7 *Canadians and Their Money,* Task Force on Financial Literacy (December 2010), page 14.
8 "The prevalence of dementia explodes after age 60, doubling with every five years of age": *The age of reason: Financial decisions over the life-cycle with implications for regulation,* Agarwal, Driscoll, Gabaix and Laibson (October 19, 2009), citing a 2006 report, *Global prevalence of dementia: A Delphi consensus study.*
9 *Alzheimer's Disease — Causes of Alzheimer's Disease,* Alzheimer Society of Canada website.
10 Rising Tide: The Impact of Dementia on Canadian Society, Alzheimer Society of Canada (2010).
11 *Mild Alzheimer's patients show rapid decline in financial skills and increased vulnerability to fraud, over one year,* Science Daily.com (February 11, 2008).
12 In the Institute's survey, respondents were asked to rate on a five-point scale (one being the most simple and five being the most complex) a number of financial tasks and decisions. Understanding how to use a cheque book and making a payment by cheque receives a score of 1.3, and identifying and explaining parts of a bank statement receives a score of 1.5.
13 Examples of these instances can be found in *A Knowledge-Based Approach to Preventing Financial Abuse of Older Adults: A Guide for Professionals* (BC Centre for Elder Advocacy Support); see pages 36 and 38.
14 In recent years, two Supreme Court cases — *Pecore v. Pecore* (2007 SCC 17) and *Madsen Estate v. Saylor* (2007 SCC 18) — ruled on the issue of whether the child who is put in joint name with the deceased parent is entitled to keep the asset by virtue of their survivorship interest. The court came to different conclusions based on the facts.

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