CHALLENGES FACING FINANCIAL PLANNERS ADVISING AGEING CLIENTS WITH DIMINISHED FINANCIAL CAPACITY

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ARTICLE INFORMATION

Article History:
Submitted 28 July 2015,
Revision: 14 October 2015
Acceptance: 28 October 2015

Key words:
Financial planners, Financial advice, Alzheimer's disease, Dementia, Best interest.

ABSTRACT

Old age can be associated with declining cognitive abilities and the development of Alzheimer's disease and dementia. These conditions generally result in a reduced ability to make sound financial decisions, that is, a reduced financial capacity. This reduction is an important issue for financial planners, but reduced financial capacity is often difficult to detect. Moreover, severe legal consequences can result for financial planners who provide what is later deemed to be inappropriate financial advice to clients with these conditions. Consequently, this article aims to help financial planners understand this condition and the actions to take when it is detected.

Acknowledgement: I thank Professor Chad Perry for his guidance and assistance. Errors are my own.

Introduction

The ageing process can be associated with neurological conditions such as stroke, Alzheimer's disease, dementia and other progressive neurological disorders associated with ageing that cause a decline in financial capacity (Marson 2013). These disorders raise particular challenges for financial planners because new skills and processes are needed when dealing with this demographic (Karp & Wilson 2011). Financial planners must recognise clients with this condition before advising on a range of financial matters (Dew, 2015), which include investing to provide adequate retirement income, funding to live in retirement villages, health care and much more.

Research on ageing and associated diminished financial capacity has been published in psychology journals, for example, *American Journal of Geriatric Psychology*, *Neurology* and *Generations*. However, that research focuses on the medical reasons for diminished financial capacity and not on the implications for financial planners providing financial advice to their aged clients.

So this paper seeks to address those implications for financial planners. The implications are discussed in four sections that focus attention on the reduced financial capacity of many in this group. The first section discusses the growth of the ageing population and explains the reasons for an associated decline in the financial capacity of many in this group. The next section provides a definition of this condition, identifies the abilities that signify financial capacity, and identifies a test to avoid confusion with lack of financial literacy. Then the third section highlights the common law courts' ruling on the validity of contracts involving individuals with diminished capacity. This section also identifies the liability issues facing financial planners for failing to detect the presence of diminished financial capacity, the 'red flags' that could indicate its presence, and the guiding principles to be used when diminished financial capacity is detected. Finally, the fourth section discusses important challenges faced by financial professionals.

The ageing population and its implications

The numbers of people aged over 65 years are increasing in many countries and will continue to increase. The US Census Bureau (2015) estimated that the population of those 65 and over in the United States represented 12 percent of total population or approximately 45 million people, but they hold approximately 34 percent of the nation's wealth (Pilon, 2011). By 2050 those 65 and over will represent 21 percent of the US population or 86.7 million people and the wealth held by older households will also rise.

This ageing trend and associated concentration of net wealth is similar in Australia. There are 3.3 million people aged 65 and over representing 14.4 percent of the population, which will increase to 23 percent or approximately 8.3 million people by 2050. The Australian household net worth in 2013 totalled $6.45 trillion and so the net wealth held by older adult households amounts to about $903 billion (ABS, 2013). In Great Britain, those aged 65 and over are estimated to represent 17 percent of the population in mid-2012, with 31 percent living in households with total individual household wealth greater than £500,000 (UK Office of National Statistics, 2011). These increases are largely because of increasing life expectancies in all developed countries with the exception of the former Soviet Union countries (World Health Organization, n.d).

However, this ageing process and longer life expectancies are resulting in an increase in elderly citizens experiencing a decline in cognitive processes, or suffering mild cognitive impairment (Stokowski, 2009). Mild cognitive impairment includes impairment in abilities such as language, memory and reasoning, although those with this condition can still perform most activities of daily living such as balance a check book and drive a car (Alzheimer's Association, n.d.). This ability to perform certain tasks can pose identification problems for financial planners because 22 percent of people aged 71 years or older who have mild cognitive impairment do not suffer from dementia (Plassman *et al.*, 2005). Dementia and Alzheimer's disease are more serious than mild cognitive impairment because they are associated with the decline in a person's cognitive processes. This decline includes difficulties with memory together with at least one other cognitive disturbance, such as difficulty with language or executive functions that include planning and carrying out tasks, abstract thinking, flexibility and decision-making (Stokowski, 2009; American Psychiatric Association, 2000). An effect of a decline in these cognitive processes would reduce a sufferer's ability to make sound financial decisions.

In brief, the 65 year old and over age group represent a significant and growing segment by household wealth of the populations of the United States, Australia and Great Britain. This group having longer life expectancies and declining mental health poses new challenges for financial planners when advising these clients with diminished financial capacity. This paper now turns to examining the meaning of financial capacity.

Diminished financial capacity

A person having the cognitive ability to make appropriate personal financial decisions has *financial capacity*. “Financial capacity [or decision making] refers to the ability to satisfactorily manage one’s financial affairs in a manner consistent with personal self-interest and values” (Gardiner, *et al*. 2015, p.82). This definition will be used throughout this research. Financial capacity involves a broad range of mental abilities, such as conceptual, pragmatic and judgemental abilities that are used across a range of everyday settings and that can vary across individuals based on their background and experience. For example, the financial skills and experience of a retired investment analyst will differ from those of a retired school teacher on a fixed income (ABA/APA Assessment of Capacity in Older Adults Project Working Group, 2005).

A decline in a person’s financial capacity does not mean that *all* aspects of this person’s decision making abilities are affected. Because this capacity has both performance and judgemental aspects (Marson, 2013), a decline in performance ability may not mean that the judgemental ability is affected, and vice versa. For example, an older person may be capable of carrying out financial transactions such as purchasing items, but not have the judgement required to spend within their financial means. Conversely, an older adult might have the judgement to assess the relative merits of competing demands on their financial resources, but lack the technical capacity to carry out financial transactions. However, an aged person may suffer mild cognitive impairment but not suffer a total loss of these abilities. This impairment could make it difficult for financial planners to recognise those with impaired decision making abilities so they need guidance on how to recognise financial capacity.

For a person to demonstrate financial capacity, he or she must be able to employ a number of cognitive abilities. There are at least nine domains of financial capacity that demonstrate financial capacity (Griffith, *et al.*, 2003, p. 454). These range from relatively simple tasks, such as being able to name coins and notes, carrying out cash transactions, to more complex tasks, such as making and explaining investment decisions. The nine investment decisions include: basic monetary skills, financial conceptual knowledge, cash transactions, checkbook management, bank statement management, financial judgment, bill payment, estate planning/wills and investment decision making.

This lack of financial capacity is usually associated with old age, Alzheimer’s disease, dementia and other diseases associated with normal ageing. So these diseases do lead to diminished ability and open ageing people to problems with financial management. For example, inability to manage their affairs or make appropriate investment decisions, inability for independent living, financial exploitation (fraud) most notably by friends and family, and the inability to make estate planning decisions. Advising on investment strategies and estate planning are important functions of financial planners. Therefore, the loss of financial capacity can pose difficulties for financial planners when advising these clients, but does a client’s confusion about their finances signal diminished financial capacity?

Once a person has Alzheimer's disease or mild dementia, skills such as understanding investment options and determining returns rapidly decline. However, financial capacity is not an all-or-nothing concept because it is task specific and mental abilities can fluctuate over time and can vary in the course of a day depending on a person's stresses and energy level (Marson, 2013). Furthermore, incapacity in one performance area does not automatically mean that capacity is lacking in another area as noted above and this is being recognised in the courts.

Courts in Australia have also recognised that financial capacity is not an all-or-nothing concept. For example, the Supreme Court of New South Wales ruled that a person who has been found incapable of managing their financial affairs may still be capable of making a will (McLelland, 1992). So a lack of understanding of financial concepts does not necessarily indicate diminished financial capacity because it may only signal a lack of financial literacy. The challenge for financial planners is in separating the two conditions and not making a misdiagnosis.

Since separating these two conditions can be difficult, a simple non-diagnostic test is needed. To avoid a misdiagnosis, three questions can test financial literacy in the elderly (Lusardi & Mitchell 2011, p. 3):

- Suppose you had $100 in a savings account which paid an interest rate of 2% per year (calculated at the end of the year). After five years, how much do you think you would have in the account if you left the money to grow: More than $102? Exactly $102? Less than $102? Do not know.
- Imagining that the interest rate on your savings account was 1% per year and the inflation rate was 2% per year. After 1 year, would you be able to buy: more than, exactly the same as, or less than to-day with the money in this account? Do not know.
- Buying a single company stock usually provides a safer return than a stock in a mutual fund. Is this statement: True? False? Do not know.

After getting answers to these three questions financial planners may be able to determine whether a client has a low level of financial literacy or a more serious condition.

In brief, financial capacity can vary between individuals depending on their past experience and education. A decline in this capacity does not necessarily mean that all decision making abilities are lost because a person may be able to perform everyday tasks but not be able to make financial decisions. This impaired ability can cause financial planners difficulties when making financial recommendations because confusion over financial matters may not be a sign of diminished financial capacity but a lack of financial literacy. However, asking clients to answer three questions aids financial planners in distinguishing between the two conditions.

Legal standards relating to capacity

But what legal standards are applied by the courts to determine capacity? Courts in common law countries apply different capacity standards to a wide range of such activities. These include entering into a valid contract, making a will, getting married, and responsibility for criminal conduct. For financial planners, the two most important activities are entering into a valid contract, and making a will.

Entering into a valid contract. Common law accepts that people have varying levels of capacity and as such, the courts make rulings taking into account the degree of incapacity experienced by a person in particular circumstances.

The following discussion is based on what applies under common law, which may vary under other legal codes. Common law of contracts recognises that the party's entering into a legal contract must have the capacity to do so. Common law recognises two capacity standards: non est factum, and soundness of mind.

When dealing with written contracts, the common law distinguishes between a person with mental incapacity who is unable to understand the general nature of a document and a person who has no understanding of the document at all (Bant 2009, p. 371). If the degree of incapacity is profound, the contract is void and held to have never existed since a person should not be held to a bargain when he/she has no idea of the document. However, this standard is not applied to all contracts.

When dealing with written contracts where the defence of non est factum is not available or unwritten contracts the soundness of mind standard is used. In this case, the level of incapacity is determined according to the particular transaction. The common law rule is that "each party shall have such soundness of mind to be capable of understanding the general nature of what he is doing by his participation" (Gibbon v Wright, 1954, p. 437). This common law rule means that if the capacity to achieve this standard fails, the contract can be set aside by the one seeking to avoid the contract obligations. These standards are particularly pertinent when making a will, which is an area many financial planners are involved in as part of their estate planning activities.

Making a will. The second important activity for a financial planner is making a will for a valid will must meet certain legal standards. The courts will judge the validity of a will if "at the time of execution the testator [person who made the will] possessed the requisite capacity and intention and if it meets certain formal requirements" (Hardingham, *et al.* 1989, p. 50). One formal requirement is for the testator to have testamentary capacity, because a testator may have a valid intention to prepare or change a will, but be deemed by the courts to not have the required capacity to do so.

A testator who has the required capacity and intention is said to have this testamentary capacity. However, if one of these elements is missing then the will is not upheld in the courts for it will not have been made with “sound mind, memory and understanding” (Banks v Goodfellow 1870, p. 565). The testator must be able to fully understand what he or she is doing in executing the will and realise the extent and character of the property they are dealing with (Hood, 1897). A testator must also be able to recognise the nature of the moral claims on their estate to which they ought to give effect (Banks v Goodfellow, 1870). Whether a person had testamentary capacity is a question of fact: if there is any doubt, the court will rule that the person did not have testamentary capacity when making the will. Therefore, recognising the existence of a client’s testamentary capacity is an important issue for financial planners.

A failure by a financial planner to recognise a client’s lack of testamentary capacity may also breach legislative provisions and court rulings. These provisions will apply to the making estate planning recommendations because a breach of these provisions may raise the risk of future legal action by the client’s spouse, children or his or her heirs.

Liability issues for financial planners. In Australia, regulators have introduced legislation governing the provision of financial advice. This legislation requires financial planners to place the client’s best interests at the forefront of their advice. Therefore, in order to ensure that the advice is in the client’s best interests, financial planners need to be confident that the client is competent in making financial decisions involving often complex financial products and not being unduly influenced by a third party such as a friend or greedy nephew. (Clemens & Hayes, 1997).

Not recognising a client with diminished financial capacity may lead to severe liability issues for the financial planner. Because a legal determination involving financial services would focus on the person’s ability to make certain transactions, such as understanding personal financial needs and goals, understanding investment and product choices, contracting for the purchase of a particular product, or giving a particular professional the discretion to manage an account (ABA, 2013). Therefore, a failure to recognise these diminished cognitive abilities and take appropriate action before providing financial advice may lead to severe legal consequences as the following criminal case illustrates.

In February 2012, Glenn Neasham, an independent insurance agent, was ordered to spend 90 days in jail on a felony-theft conviction for selling a complex annuity to an 83-year-old woman who prosecutors alleged had shown signs of dementia. In an interview, Mr. Neasham said the elderly woman, Fran Schuber, arrived at his office with her longtime octogenarian boyfriend, who had bought an indexed annuity from Mr. Neasham years before. The boyfriend, Louis Jochim, said in an interview that Ms. Schuber knew he was pleased with his annuity and wanted one as an alternative to a bank certificate of deposit. Mr. Jochom claimed that he considered that Ms. Schuber was mentally competent.

The criminal case, under a state law specifically protecting elderly people, is rooted in what happened next: Ms. Schuber and Mr. Jochim went to a local bank to withdraw $175,000 for the purchase. A bank manager then notified California's adult-protection officials, saying the woman seemed confused and influenced by Mr. Jochim, court filings show. Lake County Senior Deputy District Attorney, Rachel Abelson said in a court filing there was "sufficient evidence presented [at trial] to show that Fran Schuber was not capable of consenting to the transaction in question and evidence showed that [Mr. Neasham] knew that at the time." In an interview, Ms. Abelson said a $14,000, or 8%, commission "played into his criminal intent."

According to the insurer, Allianz, had Ms. Schuber pulled her money out within the first year of ownership, she would have had to pay a penalty equal to 12.5% of the principal. Had Mr. Neasham been more alert to Ms. Schuber's reduced financial capacity, he may have avoided this severe penalty. Although this conviction was later reversed on appeal in 2013, the Neasham trial ruling emphasises the possible consequences for financial planners of not determining a client's financial capacity before a sale. This recognition is needed before providing financial advice but there are certain red flags that may be helpful in indicating diminished capacity. These include: memory loss, communication problems, lack of mental flexibility, calculation problems and disorientation (Marson, 2013).

In addition to these red flags, there are certain behavioural triggers that can raise a financial planner's suspicion of memory loss or decline in financial capacity in older clients: missed office appointments, confusion about instructions, frequent calls to the office, repetitive speech and/or questions, missed paying bills, difficulty following directions, trouble with handling paperwork and difficulty recalling past decisions or actions. These triggers are not diagnostic, but should raise suspicions of cognitive problems that will give cause for a discussion of the issue with the client. However, there are practical issues that need to be considered when discussing financial products with aged clients suffering reduced financial capacity.

In brief, the capacity standards applied by common law courts are there to protect parties when entering into contracts and making wills, particularly those with reduced decision making abilities. The courts are beginning to impose severe penalties on financial planners who do not recognise a client's diminished financial capacity when arranging investment contracts. Therefore, financial planners need to be observant of red flags and behavioral triggers of memory loss indicating possible diminished financial capacity.

Practical implications for financial planners

The discussion above has implications for financial planners. Financial products can be difficult to understand by many people let alone by those with diminished financial capacity. This complexity imposes an ethical duty on financial planners to ensure that elderly clients have financial capacity. These ethical duties apply when:

- considering the appropriateness of investment products
- formulating protocols or procedures when advising clients with diminished financial capacity
- advising clients with diminished capacity through appropriate communications
- recognising the potential for fraud and abuse by trusted family members, friends, or strangers

Each of these four issues will be discussed in turn.

The appropriateness of investment products. Firstly, appropriateness of the investment products is a fundamental ethical requirement for financial planners. This requirement is even more critical when advising aged clients with impaired financial capacity, which is evidenced by the legal action brought against Glenn Neasham testifies. The appropriateness of investment advice can be judged against three measures: client's objectives, needs and personal circumstances.

A client's objectives and needs are identified during the discovery phase then incorporated in a written financial plan, which the advice must meet. Personal circumstances involves more than just the availability of financial resources to invest or meet emergencies, such as calls on a negative geared product following asset devaluation because this also includes the ability to make financial decisions. A sound financial decision can only be made if the client fully understands the product.

A client would not be able to fully understand the product if he or she had impaired financial ability. A financial planner is legally bound to protect a client's best interests and to exercise a fiduciary or trust-based duty when providing financial advice. Therefore, if a financial planner detects signs of dementia or other forms of diminished capacity then the client's best interests must be protected by the financial planner putting the client first and suspend the sale. Any further discussions should be conducted by involving their spouse, trusted family member or friend in the proceedings, thereby ensuring complete transparency. The fiduciary role also includes knowing how and when to refer a client to a health professional, social services agency or financial management services company, which will require well developed communication skills. This fiduciary duty is less likely to be overlooked if set procedures are put in place when clients with diminished financial capacity are detected.

Establishing protocols. Establishing protocols is also important for they avoid confusion and inconsistent dealings (Karp & Wilson, 2011), and so minimise the possibility of legal transgressions. There are a number of actions that can be included in a financial planner's protocols. For example, ask clients if they have a power of attorney and if so, include this document in the client's file and discuss the advantages and disadvantages of this document.

And, monitor the activities of an agent under a power of attorney to prevent its misuse and include procedures for having spouse or family members participate in decision making. Finally, document all activities, including a list of emergency contacts and permission to refer client to a health professional if required (Karp & Wilson, 2011).

However, protocols must not violate a person's common law rights to privacy. At common law, a person has a right not to have their personal affairs made public without their express approval. An invasion of privacy is a tort allowing an aggrieved party to bring an action against an individual who unlawfully discloses his or her affairs in such a manner so as to cause outrage or mental suffering, shame or humiliation (Black v Aegis Consumer Funding Group, Inc., 2001). Therefore, the firm's privacy policy must allow the financial adviser to reach out to a family member or to third parties if the firm suspects diminished capacity (Bandera, 2011). Finally, these protocols must ensure the firm's private policy does not violate any legislated privacy laws.

Providing appropriate advice. A third ethical requirement is to develop long-term relationships through a series of service encounters and the communication involved. The development of trust is important because the results of financial products given at point of sale may not become evident until many years into the future. This long-term nature of the relationship means that there will be a high degree of contact between the client and financial adviser therefore well-developed communication skills are needed by the financial adviser to maintain the relationship. These communication skills include several elements for example, empathy and listening skills, accurate explanation of fees and charges, being honest about risks and returns, and educating the client to encourage informed decisions (Sharma & Patterson, 1999).

The ability to communicate effectively and to gain the trust of aged clients gives the financial planner more opportunity to recognise the signs of diminished financial capacity by administering the simple tests described above. Good communication skills will also allow the financial planner to recommend forward planning to implement strategies, such as providing advice on powers of attorney, trusts and health directives. Furthermore, these communication skills will help financial planners awaken clients to the prevalence of mental decline associated with ageing, the associated costs of health care and specialised accommodation.

These costs can have a significant impact on the ability of retirees to fund their retirement over the long term and can have a major influence on the portfolio asset allocation. For example, adopting a dynamic lifestyle approach that advocates increasing the allocation of risky assets, such as stocks when a portfolio is not achieving a defined adequacy target or shifting the allocation to a more defensive allocation if the portfolio wealth is greater than the retirement target is more effective than a static pre-determined allocation strategy when used during the accumulation phase (Basu *et al.*, 2011).

This same approach has been shown to preserve portfolio wealth during the retirement draw down phase and help recover portfolio wealth following a significant health event (Drew, *et al.*, 2014). In addition, having good communication skills may provide opportunities for the financial planner to recognise the signs of undue influence by a trusted family member, carer or friend and whether they are being the victim of fraudulent activities by a third party.

The potential for fraud and abuse. The fourth implication for financial planners arises because fraudulent activities and abuse perpetrated against the elderly have become an everyday occurrence. Perpetrators employ a variety of methods to illegally obtain money and property from the unwary, particularly from the elderly. Fraud or consumer scams have been defined as “a fraudulent invitation, request, notification or offer, designed to obtain someone’s personal information or money or otherwise obtain a financial benefit by deceptive means” (ABS, 2008 p. 5). In general parlance, scams are committed against a particular system, while fraud is committed against an individual (Answers.com, n.d.), however, because they are commonly used to refer to the same activity, they will be used similarly in this research.

Fraud is one of three elements of economic crime that can be committed against older people. This economic crime is a threat to older people’s financial security, health and wellbeing. The other two being financial mismanagement and matters associated with enduring power of attorney and guardianship (Greycar & James, 2001). The most common forms of fraudulent activities committed against the elderly include: financial, housing, property stolen or misappropriated, being forced into surrendering rights or property or signing or changing a legal document, impersonation of the person to obtain property or services, carrying the cost of all domestic expenses without the contributions of other household members and being destitute and not receiving assistance from family and friends (US Department of Justice, 2015). This abuse is often perpetrated by a family member rather than by an outsider (Peterson, 2014).

Old age is often accompanied by declining mental abilities and this is often accompanied by social isolation. Social isolation can lead to loneliness, which makes the elderly more vulnerable to scams because they tend to be too trusting, gullible, live alone and don’t have someone watching over their finances (Sollitto, 2015). Elderly adults who struggle to maintain an independent lifestyle are also often exploited because they require assistance with shopping and meal preparation. This dependency gives potential perpetrators access to their finances, which may come as a shock to the elderly adult’s independent children. Notably, financial planners are not recognised as common culprits for financially abusing the elderly (Dew, 2015).

The children of elderly parents are often unaware their parents or sole parent are suffering from financial abuse because the parents find it difficult to discuss this abuse with their children. Older parents have a number of concerns, which lead to a reluctance to engage in financial conversations with their children. These concerns include a fear of: losing their independence, being placed in a nursing home, having their financial competency questioned, believing children want access to their money or pressuring them for money (US Department of Justice 2015).

Often a change in an aged parent’s behaviour can be a signal that possible financial abuse is occurring. There are several red flags that will give warning signals for possible abuse. These red flags include making: erratic or unusual transactions, frequent or large withdrawals, gifts to a caregiver and closing accounts despite heavy penalties (Dew, 2015). Further red flags indicating possible abuse can be detected by observing the interaction between elderly clients and their carers.

These interactions include carers not allowing the client to speak freely, the client appears to be intimidated by the carer, or indicating reluctance to allow the client to meet privately with you for a one-on-one meeting (Dew, 2015). Finally, a carer who is not responsible for the client's financial affairs shows keen interest in them. Any one of these interactions should signal a warning to the financial adviser.

A trusted financial planner is in a position to not only recognise possible financial abuse, but also to advise children of aged parents of the signs of financial abuse and the actions to take to protect their aged parents. They can also provide children with a range of services, such as advising on appropriate financial strategies and on the construction a financial plan to help children cope with the costs of ongoing care of their aged parents. Furthermore, if a financial planner detects financial exploitation or other abuse he or she must report the abuse to the appropriate authorities as required by their established protocols.

In brief, the complexity and variety of financial products imposes an ethical duty on financial planners to exercise their fiduciary duty and protect an aged client's best interests. This protection can be achieved by involving a family member or trusted third party in the discussions. However, written protocols need to be developed when dealing with clients with diminished financial capacity or when the financial planner suspects the client is being subject to fraudulent abuse. Furthermore, there are a number of red flags that may indicate such abuse and financial planners are able to provide important assistance to family when abuse is suspected. More research needs to be done to determine the levels of skills possessed by financial planners in recognising diminished financial capacity and the strategies they can implement to provide appropriate financial advice to their clients with this condition.

Summary and conclusion

In summary, the decline in the financial capacity of an ageing population caused by cognitive diseases such as Alzheimer's disease and dementia is an emerging problem for financial planners. Identification of reduced financial capacity is of particular importance for financial planners if they are to provide appropriate financial advice to this demographic.

The difficulty for financial planners is threefold. First, they are not trained psychotherapists and can only apply basic non-diagnostic tests to raise red flags to indicate the presence of reduced financial capacity. Second, the need for sound cognitive ability is required for making a variety of legal contracts, which includes making investment and estate planning decisions. Third, financial planners are subject to legislative, legal and ethical requirements to provide financial advice that is in the client's best interests. Therefore, recognition of clients with reduced financial capacity is of paramount importance.

The establishment of protocols will help to provide guidance when clients with reduced financial capacity are identified. Additionally, building trusting relationships with clients will allow financial planners to detect instances of fraud and abuse, and be in a position to alert family or authorities.

In conclusion, this research is important because it throws light on a decisional capacity that is of increasing importance for those affected, their families, and for their financial planners.

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