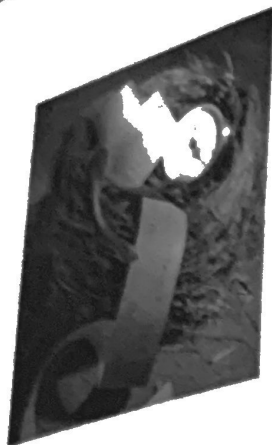




Learning Objectives

After studying this chapter, you should be able to

- Explain the need for financial planning services
- Describe the financial planning tools and process
- Identify the insurance and investment products banks offer
- Identify retirement planning considerations and products
- Describe trust services banks offer
- Discuss laws, regulations, and expectations for banks and bankers engaged in providing investment, insurance, and trust services



Introuction

Andrew Carnegie, the great American industrialist and philanthropist, advised others to "Concentrate your energies, your thoughts, and your capital. The wise man puts all his eggs in one basket and watches the basket." Few have attained the wealth Carnegie had in his day, but everyone wants to improve their financial situation in life and enjoy the stability and security that comes with that.

Most bank customers, whatever their financial status, want guidance on how to manage their finances, their "basket of eggs." Some want to set money aside for major expenses such as a down payment on a home or to pay for their children's college education. Others want to save for their retirement, realizing that life expectancies today exceed those of any previous generation. Banks can help people meet these goals, adding to the assets their customers have through investment products and protecting what their customers have with insurance products.

Many banks also offer their customers trust services, which until recently were primarily intended for wealthier customers. However, full-service banking is now available on a much broader scale; banks everywhere have expanded their business lines and are offering more trust, financial planning, wealth management, and investment products and services relevant to almost every customer's financial needs.

FINANCIAL HEALTH EQUALS PERSONAL WEALTH

The Great Recession of 2008–2009 cast a harsh spotlight on the tenuous financial condition of the typical American household. In a relatively short amount of time—in the approximately two years from the beginning of the recession to its end—U.S. households lost a combined \$12 trillion in wealth, falling to a combined \$57 trillion. Much of this loss was attributable to a collapse in the U.S. economy that caused home prices in many areas of the country to fall by 20 percent or more, and stock values to drop even more sharply.

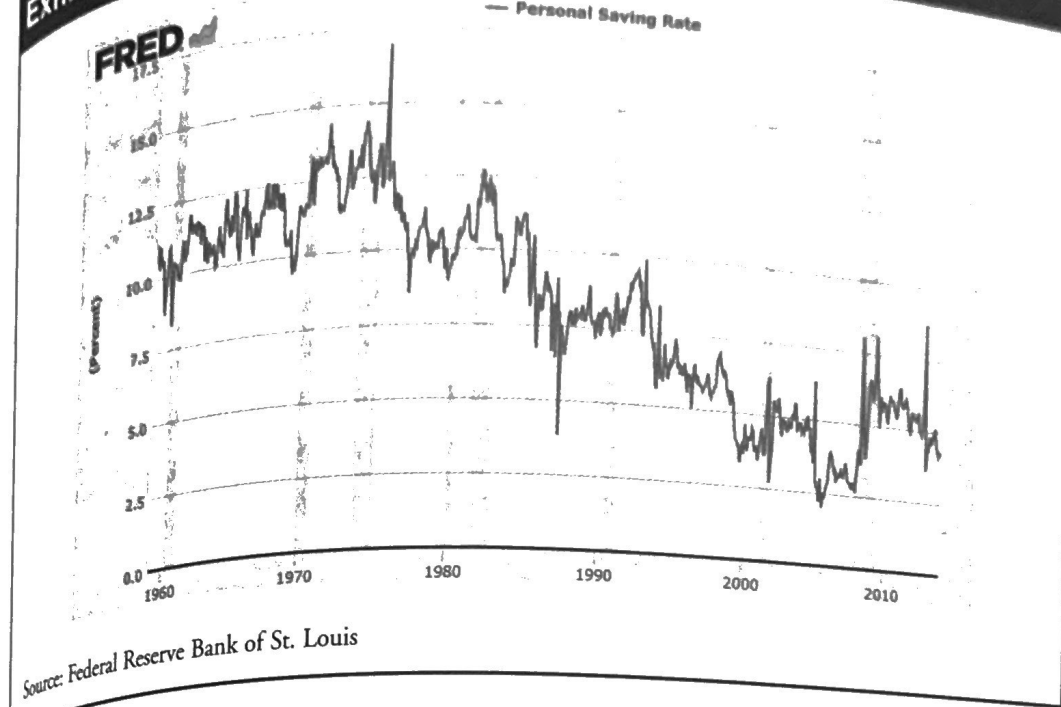
However, the dire financial condition that many Americans found themselves in could not all be blamed on a poor U.S. economy. A lot of the problem was self-inflicted. In almost every year during the 1960s and 1970s, the personal savings rate of Americans averaged 10 percent or greater. However, beginning in the early 1980s, the savings rate began a slow decline that continued for more than two decades, finally bottoming out at 2 to 3 percent between 2005 and 2008 (see exhibit 7.1). Savings only began to rebound in 2009 after the public grew worried in the midst of the recession and began once again to set money aside.

Time-Honored Principles for Financial Health

- Budget to save
- Save and invest
- Control debt
- Protect accumulated wealth

Source: Federal Reserve Bank of Dallas

Exhibit 7.1: Personal Savings Rate in the United States



Increased savings, along with a turnaround in house and securities values, means that Americans are finally regaining the wealth they lost during the Great Recession. In fact, by the third quarter of 2013, the Federal Reserve reported that U.S. household wealth had reached a record high of \$77.3 trillion.

Nonetheless, these gains have not been realized by all Americans, particularly those who do not own homes or stocks. Many Americans still hold too much consumer debt, especially in the form of credit card debt and student loans. In some markets, housing prices have yet to fully rebound, with homeowners still owing more on their mortgages than their houses are worth.

Further, many Americans approaching retirement age are also in poor financial shape. According to a recent survey by the Employee Benefit Research Institute, only 66 percent of U.S. workers have saved any money for their retirement, and 57 percent have less than \$25,000 in total savings. Those workers who have not saved for retirement have little other savings. Sixty percent have less than \$1,000 in savings and investments, and 18 percent have between \$1,000 and \$9,999. The inability of many Americans to save for retirement has serious long-term implications on both a personal and national level.

To address this national problem of excessive debt and inadequate savings, government, industry leaders, educators, and consumer interest groups have joined forces to educate Americans of all ages on the value of, and the methods for obtaining, maintaining, and restoring, financial health.

The word "wealth" conjures different images, from opulent splendor and the ability to purchase almost anything to simple peace-of-mind and the ability to pay bills on time and meet basic food, shelter, and clothing needs. Regardless, most would agree that personal financial wealth consists of assets accumulated free and clear of any obligations.

No matter what their income level, Americans face challenges budgeting for their ongoing financial obligations and managing their accumulated wealth. By

*"Annual income twenty pounds,
annual expenditure nineteen
six, result happiness. Annual
income twenty pounds, annual
expenditure twenty pounds eight
and six, result misery."*

— Wilkins Micawber in *David
Copperfield* by Charles Dickens



Did You Know ...

People whose income is below a certain level can open an individual development account (IDA) in some communities. IDAs are opened at local banks as part of a money management program suggested by a nonprofit group. Deposits are matched with funds provided by a combination of federal grants and nonfederal contributions from state and local governments, financial institutions, and the philanthropic community. IDAs are used to meet an eligible person's savings goals, such as purchasing a home, paying for education or job training, or starting a business.

IDAs can be a good opportunity for banks as well.

Opening a checking or savings account is the first step toward becoming a customer of other bank products and services, such as credit products, investments, and insurance.

serving as trusted advisors and managers of wealth, banks are helping Americans meet this challenge.

BANKS AND FINANCIAL PLANNING

The personal wealth management services that banks offer range from the most basic financial planning information to complex high-end trust and investment services. By providing these services, banks fulfill their role as trustworthy guardians of money. Banks serve as investment advisors and financial planners for consumers, corporations, pension plans, endowments, and public agencies.

FINANCIAL PLANNING GOALS

Financial planning is the drafting and implementation of a personal program to achieve specified financial objectives. The goal is to maximize income and minimize expenses to attain short-term objectives, such as an automobile purchase, and long-term objectives, such as saving funds for higher education or a comfortable retirement.

Banks offer financial planning for a number of reasons, from meeting customer requests for such services to developing long-term customer relationships. Customers who buy investment and trust products use more bank services, contributing to their bank's fee income. Furthermore, by providing quality financial planning services, banks improve their position in the community as dependable and knowledgeable advisors.

TIME VALUE OF MONEY

"Remember that time is money," counseled Benjamin Franklin. Indeed, when building personal wealth, money and time are related in many ways. The values of assets, liabilities, and earnings are affected by time.

For example, inflation can undermine the value of an asset, while a growing scarcity of an asset can increase its value. Similarly, interest can have both a negative and positive effect. On one hand, interest earned on assets such as savings accounts and bonds adds to income and, ultimately, to the value of the assets. On the other hand, interest paid on loans, such as real estate mortgages, adds to the cost of the asset and increases the owner's liability. Most homeowners count on their home to appreciate in value to offset and eventually reward them for the debt incurred when they purchase such a significant asset.

Financial planning, therefore, takes into account the interplay of time and value. To reach wealth management goals, financial plans should ensure that earnings on assets offset and surpass inflation's eroding effect on the value of money and, thus, on the assets' values as measured in terms of money. Simply put, earnings on assets should exceed the inflation rate.

RISK MANAGEMENT CONSIDERATIONS

An important aspect of financial planning is managing the **risk/return trade-off** by choosing investments and assets that are appropriate for the customer's goals and life stage. The general assumption is that younger people are willing to take more risks in the hope of greater return, but as people approach retirement, they

risk/return trade-off—The relationship between an investment's risk and its potential return; the lower the investment's risk, the lower the return, and vice versa.

look for safer investments because they have less time to recover from market changes that may result in losses. In addition to age, other personal considerations, such as a customer's risk tolerance level, will determine how risk is managed in his or her financial plan. A financially conservative investor, for example, may be more concerned with safety than return.

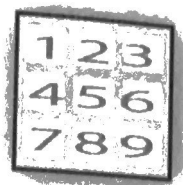
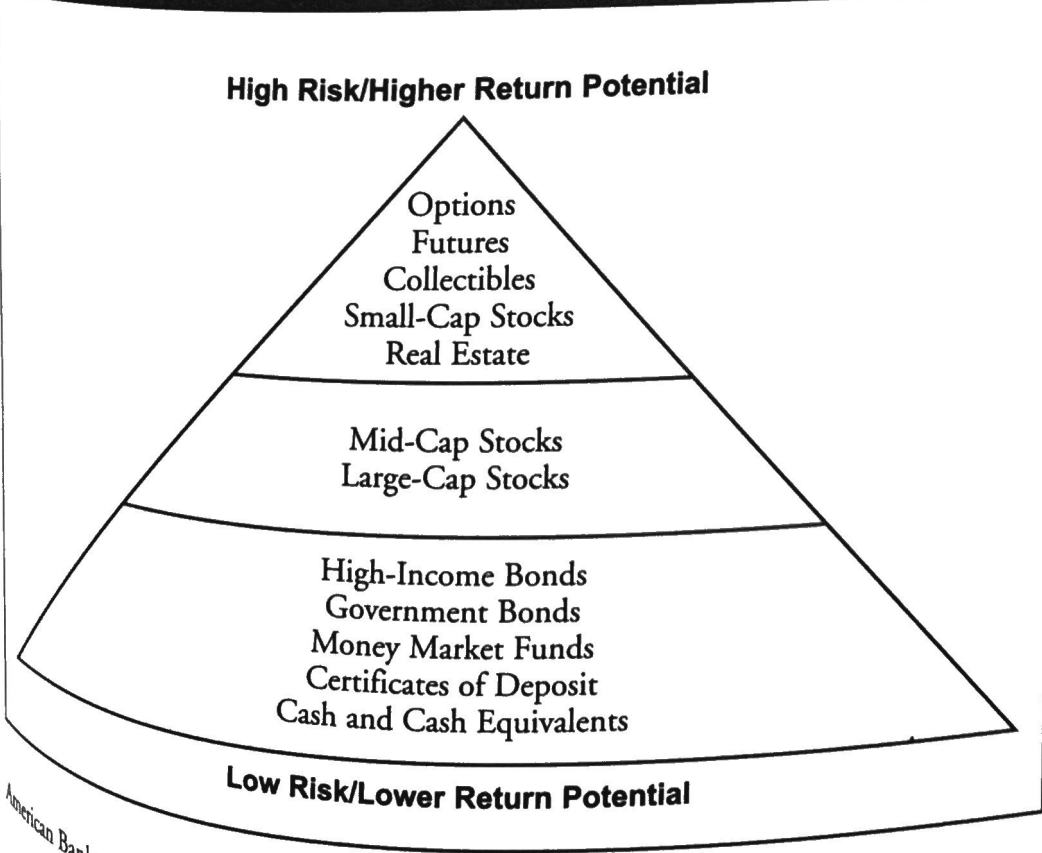
Financial advisors often think in terms of a risk pyramid for investments (see exhibit 7.2). Like the broad base of a pyramid, most people have more assets invested in cash, cash equivalents, and other liquid investments.

THE ROLE OF THE FINANCIAL PLANNER

A financial planner is an advisor who helps customers develop a plan to realize their financial objectives. An effective plan takes into account such objectives as:

- Short-term safety net
- Debt reduction
- Housing options
- Investment options
- Asset protection (such as insurance)

Exhibit 7.2: The Risk Pyramid



Determining Future Value

The calculation for determining the future value of an investment increasing per period is

$$FV = P(1+i)^{EB} \left[\frac{(1+i)^n - (1+g)^n}{i-g} \right]$$

By The Numbers

- P = present value
- 1 = initial investment
- i = interest rate
- g = increase in the investment
- EB = exponent, 0 is the end of the period and 1 is the beginning of the period

An employee invests his annual bonus of \$10,000—which will increase by 7 percent annually—for five years in a deferred compensation plan that pays 10 percent annually. If \$10,000, increasing at 7 percent each year, is invested at 10 percent annually for five years the accumulated value will be \$76,251.37.

$$\$76,251.37 = \$10,000(1+.10) \left[\frac{(1+.10)^5 - (1+.07)^5}{.10-.07} \right]$$

The Values of Money

- **Time value of money**—The idea that a dollar today is worth more than a dollar in the future because the dollar received today can earn interest until the time the future dollar is received.
- **Present value**—The amount in today's currency that future income or outlay would be worth if received or paid today.
- **Future value**—What money or assets currently in hand will be worth at a specified time if left to grow at a given rate.
- **Net present value**—The difference between the cost of an investment and the discounted present value of that investment's future earnings.
- **Net future value**—The difference at a specific future date between the sum of the future values of all earnings and the sum of the future values of all costs resulting from a current investment.

dependent—A person, such as a child, who depends on another person, such as a parent, for care and financial support.

trust—A fiduciary relationship in which one party (a person or a corporation) holds title to property for another party based on a legal agreement and the fiduciary principles of law.

Factors in Risk Level Choices

- Financial goals over time
- How long money can be invested
- Ability to take on more financial risk
- Inflation risk



Did You Know ...

Many Americans lack the necessary knowledge to improve their financial condition (commonly referred to as “financial literacy”):

- Fifty-six percent do not have a budget.
- One-third do not pay all of their bills on time.
- Thirty-nine percent carry credit card debt over from month to month.
- Forty percent are saving less than they were one year ago.

Source: National Foundation for Credit Counseling

- Education plans (personal and for dependents)
- Planning for such emergencies as disability
- Retirement strategies
- Estate planning

The planner’s job is to help the customer set priorities and make appropriate financial decisions. To do this, the plan must help the customer stay ahead of inflation, minimize costs, manage unexpected expenses, and fulfill short-term and long-term needs and objectives at each life stage.

ETHICAL STANDARDS

As in every other aspect of banking, bankers providing financial planning services must be professional and ethical. The first duty to the customer is to provide objective information, without considering which financial product brings more income for the bank. To avoid any potential conflict of interest, a banker must fully disclose all costs and requirements, such as fees, commissions, and penalties that are associated with a recommended product.

The financial planner is a generalist who helps the customer coordinate the work of specialists such as accountants, brokers, lawyers, and insurance agents. When offering financial planning services, bankers must be careful not to stray into areas beyond their professional expertise and licensed qualifications, such as giving specific legal advice that is more appropriate for a lawyer to give or tax advice that is more appropriate for a certified public accountant to give. Although the planner would achieve the plan’s objectives, the choice should remain with the customer.

MINIMIZING TAX LIABILITY

Although bankers must be careful to avoid the unauthorized practice of law, they can inform customers about the tax benefits of products customers are considering for their financial plans. In addition to contributions to deferred compensation plans, such as 401(k) plans, customers may open individual retirement accounts (IRAs) or buy annuities to be drawn on after they reach retirement age and are typically in a lower tax bracket. They may choose to invest in municipal bonds, which provide income that is traditionally exempt from federal taxes. They may donate to charitable organizations, or they may set up **trusts** into which they put assets for the benefit of others and thus avoid estate taxes on those assets when they die. For the same reason, customers may buy life insurance. Minimizing costs or liabilities, including taxes, should be factored into a customer’s financial plan.

FINANCIAL PLANNING PROCESS

The financial planning process begins with an analysis of a customer’s current position, including net worth, and a discussion with the customer about his or her financial needs and goals. Using this information, cash flow and investment strategies are designed and incorporated into a plan, which is then implemented by the customer

and qualified experts. Financial plans should be reviewed, usually annually, to identify any needed modifications related to changes in the customer's life and goals.

CUSTOMER LIFE STAGES

Although everyone needs a financial plan, a customer's life stage will affect the services and products a bank may recommend. Knowing the customer's situation and life stage helps the financial planner build a relationship, understand the customer's financial position, and make meaningful contributions to his or her plan.

Young Adults

Adults in their early twenties are fairly new to the job market. They are still getting their bearings as they handle an independent life and take on adult responsibilities. Most need a savings account to build liquidity in case of an emergency. Many have experience using checking accounts, debit cards, and credit cards, but it is a good idea to inquire whether they are managing these bank services well. They probably will want to buy a vehicle and eventually a home, and they typically will need loans for these purchases. Young adults usually do not need much life insurance and might benefit more from disability insurance. Even if they receive disability insurance from their employer, they may need more coverage depending on their life style and working situation. When they are ready to invest, depending on their risk tolerance level, young adults usually begin at the middle of the risk pyramid, buying stocks that have potential for **appreciation**.

Adults with Children

Adults with children need comprehensive financial planning. They probably should aim for long-term growth without high risk because they need to build assets as well as meet current needs such as housing and education. Adults with children may elect to invest in stocks and a growth mutual fund, with perhaps a conservative municipal bond fund, such as those at the lower and middle levels of the risk pyramid, in addition to their more liquid savings accounts. Adults in this segment should take advantage of any 401(k) benefits or contribute to IRAs and invest in long-term certificates of deposit.

Adults with children should also consider educational savings accounts. In addition, both spouses need life insurance; they should also make sure that their mortgaged property is properly insured for replacement cost and that they have other property and liability coverage. Given their responsibilities, adults should be encouraged to make wills, specifically naming guardians for any minor children. If they have sufficient assets, adults with children should also seriously consider estate planning, especially trusts.

Empty Nesters

Older adults who no longer have to worry about raising and educating children can live with less asset growth and more stability. Although older adults may no longer have the costs of providing for dependents, other costs, such as health care expenses, may increase, so there is an ongoing need to generate some income from investments

Financial Planning Steps

- Determine customer's needs
- Prepare a net worth statement
- Identify short-, medium-, and long-term goals
- Decide how to bring the present position into balance
- Prepare a cash flow strategy
- Draw up a full plan
- Put the plan into action
- Reassess the plan regularly

appreciation—The increase in the value or usefulness of an asset.

estate—The assets (property) a person owns such as real estate, cash, stocks, bonds, and all other personal property, and the person's liabilities (debts) and other legal obligations. Often used to describe the property of a decedent.

Situation

Phyllis is working on her financial plan. Her bank provided her with a worksheet to help determine her net worth. After adding up all her assets, including a car she received from her parents and an inheritance from her grandmother, and then deducting her student loans, she determines she has a net worth of \$30,000. That is quite good for a young professional not long out of college, so she thanks her mom and dad for teaching her good savings habits. Now Phyllis is ready to meet with her banker and the bank's financial planner to discuss strategies to build her personal wealth.

heir—A person who inherits property.

to supplement prospective Social Security and private pension income. For investment empty nesters may put half or more of their money in a mix of short- and long-term municipal bond funds, some in money market funds, and perhaps a small percentage in an aggressive growth fund. They will not need much life insurance once the children are independent, but they should certainly consider long-term care insurance. Empty nesters definitely should consider estate planning if they have not done so already.

Variations on Standard Life Stages

Although these descriptions and possibilities apply in most situations, financial planners undoubtedly will encounter variations. Some young adults have been working since their teen years and already have good liquidity positions in their savings accounts. Some customers may never marry, or they may have inherited a small fortune and have no experience handling large sums. Other customers never will enjoy an empty nest because of the need to care for a parent or a child with special needs. In all situations, there will be bank products—from savings to insurance to investments and trust-related services—that meet the unique needs of customers.

FINANCIAL PLANNING GOALS

After listening carefully and gathering all the necessary background information, financial planners then discuss with customers the specific areas that need to be addressed when building their plan. Goals need to be set to:

- Cope with current demands, such as food, housing, and transportation
- Protect against personal risks, such as physical incapacity and property loss
- Set aside funds for emergencies, education, and investments
- Prepare for retirement
- Minimize taxes
- Provide for **heirs**

Some financial advisors think in terms of “buckets” for different purposes, one for immediate needs and others for a variety of future needs. A good financial plan will cover how assets will be managed and by whom. Investments in a mutual fund, for example, require less customer attention than managing individual stocks.

Among other considerations, financial plans must ensure that funds are available when they are needed; liquidity is important for stability.

FINANCIAL PRODUCTS

Banks have the authority to provide brokerage services, including investment management services, through subsidiaries or affiliates. Trust departments also provide these services, usually once a trust is established. By providing a mix of savings, insurance, and investment products, banks help customers achieve their investment goals such as maintaining liquidity, preserving capital, minimizing risk, or generating income. Financial products can be categorized by the risk of loss.

Conservative-Growth Assets (Lower Risk)

Traditional bank products such as savings accounts, money market accounts, and certificates of deposit are conservative assets that focus on protecting principal and generating some income. They are typically used to meet everyday expenses and often provide a small investment return. Many of these products are liquid and insured by the Federal Deposit Insurance Corporation (FDIC). (See bottom level of the risk pyramid in exhibit 7.2.)

Moderate-Growth Assets (Moderate Risk)

These assets have the potential to increase both principal and income but at moderate rates. Some examples of these types of investment products are municipal bonds and stock in larger companies (commonly referred to as **mid-cap stock** or **large-cap stock**), as measured by the market value of their shares of stock. However, these investments are not FDIC-insured. (See middle level of the risk pyramid in exhibit 7.2.)

Aggressive-Growth Assets (Highest Risk)

Investments in the aggressive asset growth category are characterized by increased risk, but they offer the possibility of higher returns than conservative and moderate growth products. Examples include investments in the stock of small companies (**small-cap stock**) or new companies and those in emerging markets. Real estate, commodities, and high-yield bonds are also considered high-risk investments. Only knowledgeable investors with ample income and liquidity usually consider these investments. Because the risks are great, these investment products usually are part of a diversified portfolio. They should not be the main investment vehicle. (See top level of the risk pyramid in exhibit 7.2.)

NET WORTH STATEMENT

All financial accounts can be expressed in numbers. After gathering information about needs and goals, the details of a customer's financial position must be analyzed to assess his or her current net worth. Exhibit 7.3, next page, is a simple worksheet that both the financial planner and customer may use as a starting point. The **net worth**—or a person's personal wealth—is determined by subtracting total liabilities from total assets.

$$\text{Assets (owned)} - \text{Liabilities (owed)} = \text{Net worth}$$

Assets that are accumulated for personal wealth should be separated from assets that are used for current needs, which are not subject to appreciation. For example, an automobile may be an expensive asset for a young adult, but it does not generally appreciate after it is purchased and used. Instead, it **depreciates** in value. Thus, a car is not an asset that generally increases in value and accumulates personal wealth. Rather, it is an asset that is used to satisfy current needs.

Often customers have not thought about the elements of their financial situation that go into a net worth analysis. The net worth analysis helps clarify where current allocations are out of balance. Is the customer spending too large a percentage of his or her income on housing or to pay down debt, for example? Questions like

large-cap stock—Generally, stock of companies whose market value is greater than \$10 billion.

mid-cap stock—Generally, stock of companies whose market value is between \$2 billion and \$10 billion.

small-cap stock—Generally, stock of companies whose total market value is less than \$2 billion.

net worth—The difference between total assets and total liabilities as calculated for an individual or business.

depreciation—The decrease in the value or usefulness of an asset.

this are part of the value of financial planning because they help a person evaluate where money is available, where current spending goes, and where the gaps are between the current financial picture and the one the customer envisions for the future.

Exhibit 7.3: Net Worth Worksheet

Assets		Liabilities	
Cash on hand	\$ _____	Accounts payable	\$ _____
Checking accounts	\$ _____	Credit cards	\$ _____
			\$ _____
Savings accounts	\$ _____	Health care bills	\$ _____
	\$ _____		\$ _____
	\$ _____	Other	\$ _____
Stocks, bonds, other securities	\$ _____	Notes payable	\$ _____
Cash value of life insurance	\$ _____	Vehicle notes	\$ _____
Amounts owed by others		Installment purchases	\$ _____
Cash	\$ _____	Bank loans	\$ _____
Promissory notes	\$ _____	Life insurance loans	\$ _____
Real estate		Taxes due	
Home	\$ _____	Federal	\$ _____
Vacation home	\$ _____	Property	\$ _____
Income-producing real estate	\$ _____	State and local	\$ _____
		Other	\$ _____
Vested pension (present value)	\$ _____	Mortgages	
	\$ _____	Home	\$ _____
	\$ _____	Other	\$ _____
401(k) or other company plan	\$ _____	Informal loans from others	\$ _____
Annuities	\$ _____	Other	\$ _____
Investments in a business	\$ _____		
	\$ _____		
	\$ _____		
Other assets			
Home furnishings (discount 15% a year since purchase, or estimate 5% of the home's value)	\$ _____		
Sports equipment	\$ _____		
Art, antiques, and other collectibles	\$ _____		
Cars, boats, and RVs (Blue Book values)	\$ _____		
Other			
Total assets	\$ _____	Total liabilities	\$ _____
<i>Minus total liabilities</i>	<i>(\$ _____)</i>		
Net worth	\$ _____		

CASH FLOW STRATEGY

Every financial goal has an allocation of resources. The net worth analysis helps refine and prioritize goals, identify them as long- or short-term, and draw up a cash flow strategy. For most customers, this information will be used to generate a monthly budget, calculate monthly income and expenses, and make adjustments to their overall financial plan. Exhibit 7.4 illustrates a monthly cash flow plan for a young bank customer. By adjusting income and expenses, a person can generate additional funds to save, invest, or contribute to a retirement plan.

In combination, the net worth analysis and cash flow strategy help the financial planner and customer objectively consider how the plan can accommodate life's unexpected financial crises—high inflation, job loss, a natural disaster, home damage, or a debilitating illness, for example. Recognizing such possibilities while they still seem remote is the foundation of a good financial plan. The plan will ensure that, in addition to cash for day-to-day needs, other liquid assets will be available for emergencies and insurance will be purchased to protect against specific crises.

Average Annual Household Expenditures in 2012:

• Food	\$6,599
At home	\$3,921
Away from home	\$2,678
• Housing	\$16,887
• Apparel and services	\$1,736
• Transportation	\$8,998
• Health care	\$3,556
• Entertainment	\$2,605
• Cash contributions	\$1,913
• Personal insurance and pensions	\$5,591
• All other expenditures	\$3,557
TOTAL	\$51,442

Source: Bureau of Labor Statistics, 2013

Exhibit 7.4: Monthly Cash Flow Plan for a Single Working Person

	Income		
	Current	Change	Adjustment
Salary	\$2,350		\$2,350
Commissions	250	250	500
Interest on savings	500		500
Other income			
Total income	\$3,100	\$250	\$3,350
	Expenses		
	Current	Changes	Adjustment
Rent	\$950		\$950
Renter's insurance	30		30
Electricity	20		20
Transportation	50		50
Water	25		25
Telephone	50		50
Internet service	45		45
Insurance	50		50
Charitable donations	0		0
Credit card interest	25		25
Groceries	250		250
Clothing	200	-50	150
Student loan payments	100		100
Gym fees	80		80
Entertainment	200	-50	150
Miscellaneous	100		100
Total expenses	\$2,175	\$-100	\$2,075
Monthly net	\$925		\$1,275
Available to save, invest, or contribute	\$925		\$1,275

INSURANCE PROTECTION

Insurance, an established way to preserve assets, is vital to risk management and thus to a financial plan. Most states require property and liability insurance for motor vehicles, for example, and banks require insurance for homes on which they hold the mortgage.

When the Gramm-Leach-Bliley Act (GLBA) was enacted, banks were permitted to offer a full range of insurance products. Banks may act as brokers by offering product lines from different insurance companies. Financial holding companies may underwrite insurance and annuities, either directly or through a nonbank affiliate. Insurance products tied to investments, such as whole and variable life insurance policies and annuities, are considered **nondeposit investment products** and are not FDIC-insured. Noncredit-related insurance products offered by banks include life, health and disability, long-term care, property, and liability insurance.

nondeposit investment product

—Any financial product with an investment component that is not a deposit product and thus not insured by the Federal Deposit Insurance Corporation (FDIC). Stocks, bonds, insurance products, and government and municipal securities are examples.

premium—(1) The payment for insurance coverage in either a lump sum or installments; (2) the amount or percentage above face value at which securities are bought or sold.

LIFE INSURANCE

Life insurance replaces the income the policyholder was contributing to the family when he or she died. Single people with no dependents usually need only enough life insurance to cover funeral expenses and unpaid debts. Adults with dependents need more life insurance to ensure that their dependents' future living expenses, including care giving, are covered. Life insurance generally is categorized as term or whole life.

Term Life Insurance

For term life insurance, the purchaser pays a specified amount of money for a specified amount of life insurance for a period (term) of one to 30 years. At the end of the term, no excess **premium** remains and the contract ends. Premiums for term life insurance may start low, but rise dramatically as the insured ages because the risk of dying increases with age.

Whole Life Insurance

Whole life insurance is both an insurance product and an investment vehicle. So long as the premiums are paid, the policy remains in force for the life of the insured. The policyholder pays a fixed premium to the insurance company, which invests it in stocks, bonds, money market instruments, or other assets, depending on the product features. In addition to paying a stated amount in the event of the insured's death, a whole life insurance policy accumulates a cash value that the policyholder can redeem or borrow against. The policy may pay a fixed or variable return, and income taxes on the gain do not have to be paid until the policy is cashed. Premiums for whole life insurance tend to be higher in the early years than the cost of term insurance because they are used to build the policy's cash value. Whole life premiums then level off or lessen as the insured ages, reflecting the increase in cash value.

Term Life Versus Whole Life

- **Term life**—Short-term insurance with no savings element.

- **Whole life**—Long-term insurance with a savings element.

Other Types of Life Insurance

Other types of life insurance products include variable life insurance and universal life insurance, both of which separate the insurance protection from the savings

part of the policy. This means the buyer assumes more risk on the savings end in the hope of a better return. Both are interest-sensitive. In contrast, traditional whole life is not interest-sensitive. This means that whole life insurance is inherently safer, but because it is safer, the return is lower and the cash value builds more slowly.

Life insurance may not be the best way for all customers to build cash for later years. If life insurance is not needed to take care of a spouse or dependents, customers might benefit more by putting their money into alternative investments such as certificates of deposit, U.S. Treasury securities, mutual funds, or bonds.

Credit life insurance is similar to term insurance in that there is no savings feature. Instead, it is purchased to pay an amount equal to that owed on a loan. Banks sell credit life insurance policies in conjunction with bank loans. If the insured dies when the loan is still outstanding, the loan is paid off rather than having the debt passed on to the deceased's estate.

HEALTH, DISABILITY, AND LONG-TERM CARE INSURANCE

Rising health care costs make being injured or sick expensive. For this reason, health insurance should be an important part of any financial plan. Group health insurance premiums paid through an employer, or a professional association, generally are lower than premiums for individual policies because the risk is spread over a large group of insured. Shared risk is also the principle underlying the creation of health insurance marketplaces by the Patient Protection and Affordable Care Act (also known as the ACA or "Obamacare"). The ACA requires all individuals to have health insurance, either through their employer or through individual policies purchased from federal or state marketplaces.

Most basic health insurance policies set time and dollar limits on benefits for hospital room and board and may pay only a percentage of medical and surgical costs. Because basic policies may not fully cover health costs, customers may want to buy supplemental medical insurance for additional protection against the high cost of serious and continuing illnesses or injuries. Insurance policies are also available that cover vision, dental care, prescription drugs, and nursing home care.

Disability insurance is as important as life insurance because, statistically, a person is more likely to be disabled—temporarily or permanently—before retirement age than to die. Because the chances of becoming disabled increase with age, coverage is especially important for older workers. Disability insurance pays a weekly or monthly income benefit if the policyholder is partially or totally disabled due to a covered injury or illness. Employers often offer group disability income coverage to their employees, but individual policies are also available.

Long-term care insurance is becoming a necessity as life expectancy increases. A healthy retirement fund or savings plan can be depleted quickly by the cost of nursing home care. A long-term care policy supports an individual who is chronically ill or functionally handicapped, which is commonly defined as being unable to walk, bathe, dress, or perform other basic daily living activities. Services covered may include home health care, care in assisted living facilities and nursing homes, respite care, and hospice care. Long-term care policies typically are issued to individuals between ages 30 and 85. As the U.S. population ages, the percentage of people

Situation

George Morgan is concerned that his family does not have enough money on hand in case of an emergency. After talking to his banker, he sets up a separate savings account and arranges to have \$300 transferred into it every month from his checking account. He makes sure this account is not accessible by ATM. The banker assures him that, once he reaches a certain minimum balance, he will begin earning a higher interest rate. Then his banker shares with George a brochure about the bank's insurance products and explains the features and benefits of life insurance. George thanks the banker, takes his business card, and makes an appointment to purchase some insurance.

needing long-term care is increasing. Consequently, long-term care policies have become a popular form of insurance.

PROPERTY, TITLE, AND VEHICLE INSURANCE

Property insurance protects the value of things a consumer owns—homes, boats, jewelry, silverware, money, and so forth—that can be lost to fire, theft, lawsuits, natural disasters, or other events. Home replacement cost coverage, which normally covers the cost to rebuild a structure using modern materials according to current building standards, is recommended.

Title insurance protects homebuyers from financial loss due to questions about property ownership. It differs from property insurance in that it protects the title of the property rather than the property itself. If someone came forward with a valid claim on property that, for example, had been surveyed incorrectly, title insurance would reimburse the owner for the loss.

Vehicle insurance typically includes coverage for both personal liability and collision arising from the ownership, maintenance, or use of automobiles, motorcycles, snowmobiles, and other motorized vehicles. Vehicle liability insurance covers the bodily injury or death of people caused by the insured. Claims for bodily injury may include medical bills, loss of income, or pain and suffering. Liability coverage also extends to damage caused to property of others. Collision coverage applies to losses arising from physical damage to a covered vehicle or other object. Vehicle insurance usually is required by state law.

LIABILITY INSURANCE

Liability or casualty insurance protects an individual or business against losses resulting from bodily injury or property damage suffered by other persons. These policies normally cover legal expenses, medical expenses, and funeral expenses incurred by persons who are injured or killed, and the cost of repairing or replacing damaged property. Professional liability insurance protects the insured against claims arising out of the practice of professional services.

INVESTMENT SERVICES

Banks or financial holding companies may offer investment and brokerage services through a third-party arrangement, a joint venture, or an in-house brokerage, as follows:

- **Third-party arrangement.** Banks arrange for a licensed brokerage firm to operate on their premises, for which they are paid a fee. Earnings are lower this way than when a bank offers the services itself, but it has fewer responsibilities. This arrangement simply makes the services available to the bank's customers.
- **Joint venture.** Banks arrange with broker-dealers to sell securities, with employees working directly for either the bank or the broker-dealer. Those working for the broker-dealer generally are licensed and registered representatives who have taken qualifying exams. The licensed broker-dealer must supervise any brokerage functions performed by bank employees.

• **In-house brokerage.** Banks sell their own discount or full-service brokerages, formed either as bank subsidiaries or through affiliates in a financial holding company. Discount brokerages sell investment products and services but do not offer investment advice. Therefore, they are typically less expensive than a full-service brokerage. Full-service brokerages sell securities and offer investment advisory services. They may perform the same services as large nonaffiliated brokerage houses, including underwriting and dealing in equity securities.

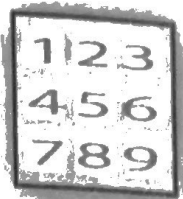
Because investment products, such as stocks, bonds, annuities, and mutual funds, are not bank deposits, they are not FDIC-insured. Banks must make sure that customers understand this important difference before selling them a nondeposit investment product.

INVESTMENT STRATEGIES

The three basic investment strategies are conservative, moderate, and aggressive. Determining the appropriate strategy will depend on the customer's risk tolerance and return objectives. Factors that influence the decision are life stage, personal circumstances, and financial plan goals. Common motivations are to safeguard or increase principal, produce income, or pursue high returns.

The investment choices shown in the risk pyramid in exhibit 7.2 correspond to investment strategies. Conservative investors looking to safeguard principal probably will have a **portfolio** heavily weighted toward cash equivalents, such as certificates of deposit and money market funds, as well as lower-risk investments such as highly-rated bonds. Moderate investors will often seek to maintain a balance of principal maintenance and growth, and are likely to have a mix of stocks and bonds. Aggressive investors seek capital growth and usually carry a portfolio that is heavily weighted in equity investments, including some stock in small cap, international, and emerging market companies.

For all three strategies, **diversification** of the portfolio is usually a standard recommendation.



By The Numbers

The Power of Compound Interest

Compound interest is interest paid on previously earned interest as well as on the original deposit or investment.

$$P = C(1+r/n)^n$$

P = deposit or investment value at maturity

C = initial investment

r = interest rate (expressed as a decimal:
for example, 6 percent = 0.06)

n = number of times per year interest is compounded

t = number or years invested

If C is \$10,000, r is 6 percent, n is 1 (annually), and t is 1, what would P be at maturity?

Answer: \$10,600.00

Now, what is the future value when interest is compounded more frequently (only n changes)?

n	P
2 (semi-annually)	\$10,609.00
4 (quarterly)	\$10,613.64
12 (monthly)	\$10,616.78

portfolio—The assets owned by one organization or person and managed as a collective whole to reach specific investment goals.

diversification—A method of decreasing the total risk of investments by investing funds in different kinds of assets.

dividend—Payments made by a corporation to its stockholders. The payments are based on a percentage of the corporation's after-tax earnings and are usually made quarterly.

closed-end fund—An investment fund that allows only an original prescribed number of shares to be distributed. It raises substantially all of its funds at the time the fund is established. The fund is traded like a stock on an exchange. Compare to open-end fund.

open-end fund—A mutual fund that sells new shares directly to new investors and redeems shares at the market price when investors wish to sell. Assets in the fund increase or decrease as investors move money into or out of the fund.

annuity—An insurance product that provides a systematic payment for a specified period, usually a number of years. Payments typically are made monthly but can be made quarterly, semiannually, or annually.

annuitant—The beneficiary of an annuity; the person insured under an annuity plan and on whose life expectancy annuity payments are based.

Stocks

A share of stock represents a share of ownership interest in a company. For the issuing company, stocks provide capital. For investors, stocks often provide a share of the company's earnings in the form of **dividends** (although dividends are not guaranteed) and an increase in the stock's price resulting from appreciation. Because a stock can lose value, it is a higher-risk investment than an insured bank product, such as a certificate of deposit. Historically, however, the return on stocks has outpaced that of many other investment types, making them a good investment choice for the long term.

Bonds

Investors who buy bonds are, in effect, lending money to the issuing corporation or government authority. Corporations issue bonds to improve their business, such as building sewer systems or schools. Federal, state, and local government authorities issue bonds for specific purposes until the bond's maturity date, at which time the face value is returned to the investor. Income from most municipal bonds usually is exempt from federal, state, and local income taxes.

Municipal or corporate bonds carry varying degrees of risk, depending on the issuer's fiscal soundness, fluctuations in interest rates, and the nature of the funded project. Like stocks, bonds can lose or gain value. This happens when a bond's interest rate is less than or more than the prevailing interest rates for similar bonds.

Mutual Funds

A mutual fund is a fund operated by an investment organization, such as a mutual fund company, that pools money from many investors to purchase large amounts of assets. The assets may include stock in companies, bonds, or commodities such as gold. Mutual funds make it possible for individual investors to diversify their assets by owning a small percentage of a large pool of assets. Furthermore, mutual funds are managed by investment professionals who know more about the assets than the average investor. The initial investment often is low, and risk is spread over all the securities in the fund's portfolio.

Mutual funds may specialize narrowly, perhaps investing only in health care stocks, "green companies," companies operating internationally, or municipal bonds. Funds may invest for aggressive growth, income, or security. Index funds buy the stocks featured in a specific market index, such as the Dow Jones Industrials. Funds may also be either closed-end or open-end. **Closed-end funds** sell a limited number of shares, after which the fund is closed to new investors. **Open-end funds** issue shares continuously to investors.

Annuities

The primary benefit of **annuities** is to pay financial benefits during the lifetime of the **annuitant**, who usually is the investor. In effect, investors are paying the insurance company that sold the annuity to help them manage their money.

The two basic types of annuities are deferred (pay-in), for which the investor makes regular contributions over time and defers payments until later, and immediate

(*annuity*), in which the investor puts up the money first and then has disbursements at regular intervals during a set period or the annuitant's lifetime.

Annuities may cover more than one person ("joint and survivor"), and the rates of return may be fixed or variable. Fixed-rate annuities promise the same payout amount throughout the annuitant's lifetime. Variable annuities come in several forms, depending on how the insurer invests the funds. The payout amount and the interest rate of variable annuities are not guaranteed.

PORTFOLIO MANAGEMENT

Successful investors not only buy stocks and hold them for long periods, they also regularly monitor how their investments are doing. At least once a year, they review everything they own to make sure it is still making the expected contribution toward their financial goals. Securities held by the mutual funds in which they are invested are reviewed to make sure the funds are providing the required diversity. Any major change, such as a divorce or the birth of a child, should trigger a review of the customer's financial plan and investments so that the portfolio may be rebalanced accordingly.

Most banks do more than just sell investment products. Through holding company affiliates or nonaffiliated broker-dealers, banks provide investment management services and advice to both individuals and corporations.

Asset Management Accounts

Asset management accounts provide a convenient way for customers to consolidate investments, which then can be accessed via check or debit card. Typically, a minimum initial investment is required and a fee is charged, although the fee may be waived if a required minimum balance is maintained. In return, customers are provided up-to-date account information online or in monthly statements, an annual summary statement that recaps all account activity, a daily sweep of credit balances, direct deposit services, and dividend reinvestment services.

Trading Accounts

Trading accounts allow customers to research and place trades either online or through a bank-affiliated financial consultant. Access to proprietary research, such as third-party stock research and mutual fund profiles, is typically offered. Customers may trade in a wide array of investments, including stocks, bonds, and mutual funds. Trades are subject to commissions and fees, which may be waived for active traders and customers who maintain high balances in bank-affiliated investment or deposit accounts. Customers usually have online access to trade confirmations, account histories, balances, and positions.

RETIREMENT PLANNING

As life expectancies continue to increase, financial assets are stretched over more years. Therefore, retirement planning is more important than ever to ensure an adequate lifestyle after retirement. However, while income needs are greater than ever, the

Banker Profile



Shelly Klein once worked as an investment banker at a Wall Street firm. Her job paid well, but required long hours, and the commute to her New Rochelle home was long. Shelly was under pressure to produce increasingly higher levels of sales to bolster the firm's commissions and fees. This life was not what she planned for in college. Helping people improve their financial position from bad-to-good and good-to-even-better was one of the personal rewards she sought. She left investment banking and joined a bank's wealth management department. Now, Shelly Klein, CTFA, is happy with her life. Although she still needs to book business, she has more time to build relationships with customers, volunteer through the bank's civic outreach programs, and enjoy the fruits of her good work.



Did You Know ...

A 20-year-old investing \$3,000 per year in an IRA at an 8 percent return can expect the IRA's value to be more than \$1,200,000 by age 65. To demonstrate that it is never too late to improve future income, a 40-year-old investing \$3,000 for 25 years can expect the investment to be worth more than \$200,000 by age 65.

sources of that income are growing more uncertain. Social Security only partially meets the financial needs of most retirees, and fewer companies offer pension plans that provide a defined benefit payment that can be relied upon each month. In short, most Americans have a greater responsibility than ever to fund their own retirement needs.

As noted earlier, Americans are, as a group, falling short in retirement savings, even though the federal government has made it attractive to save for retirement via tax-deferred IRAs and 401(k) plans. As with other aspects of the financial planning process, banks also have an important role to play in the effort to prepare customers for life after retirement. However, before a customer's retirement needs can be assessed, his or her current financial position must be known. Retirement planning necessitates answers to questions such as these:

- What are the customer's current expenses?
- What major expenses, such as those for a chronic medical condition, are likely to continue?
- What major expenses, such as college tuition or medical care, are likely to occur? When will they begin and end?
- Does the customer have life, health, and property insurance? How will insurance needs change over time?
- When does the customer or the spouse plan to retire?
- Where does the customer plan to retire—in the same area and home or elsewhere?
- What does the customer plan to do in retirement? If plans include work, what income can be expected?
- What health problems might prevent the customer from working?
- What assets does the customer already have for retirement?
- How much, therefore, will the customer need for retirement?

Answers to these questions will help customers identify a retirement income goal. Customers will be able to estimate what they will need and begin to think about how to reach their goal. Doing so may mean acquiring skills to do a new kind of work or putting more money aside now so it can grow for retirement. Exhibit 7.5 contains a worksheet that bankers can use to help customers estimate their retirement income needs.

SOCIAL SECURITY AND PENSIONS

Most Americans contribute to Social Security throughout their working lives and become eligible for full benefits in their mid-60s. However, the age of eligibility is edging upward. For example, people born between 1943 and 1954 receive full benefits when they are 66. Those born in 1960 or later will start receiving full benefits at 67. Social Security benefits can be received as early as age 62, but the benefit amount is reduced by a defined percentage for every year the benefit is taken before

Exhibit 7.5: Retirement Saving Worksheet

Using a simple worksheet like this one can help customers understand where they are today, where they'd like to be tomorrow, and what must be done to get there.

Before starting, customers need to decide how much income they will need annually. A common rule of thumb is 75 percent of current income. Customers also must decide how long they will need that much annual income. For people retiring at age 65, 20 years is reasonable. Customers then might plan to take 5 percent a year out of principal accounts, such as an IRA.

The Social Security Administration sends annual statements of the monthly benefit a taxpayer might expect to receive on retirement. This amount should be multiplied by 12 to calculate the annual income.

<i>Income Source</i>	<i>Principal</i>	<i>Annual Income</i>
Social Security	NA	\$
Pension	NA	\$
401(k) or equivalent		\$
IRAs		\$
Savings		\$
Other assets		\$
1.		\$
2.		\$
3.		\$
4.		\$
5.		\$
Total available annual retirement income		\$
Annual income needed		\$
Annual income surplus or shortfall (+/-)		\$

full retirement age. The benefit reduction is approximately 30 percent when taken at age 62. Likewise, those who wait until after their full retirement age to take Social Security receive a correspondingly larger benefit when they retire. The benefit increase is 8 percent annually between full retirement age and age 70, after which time the amount of benefit no longer increases.

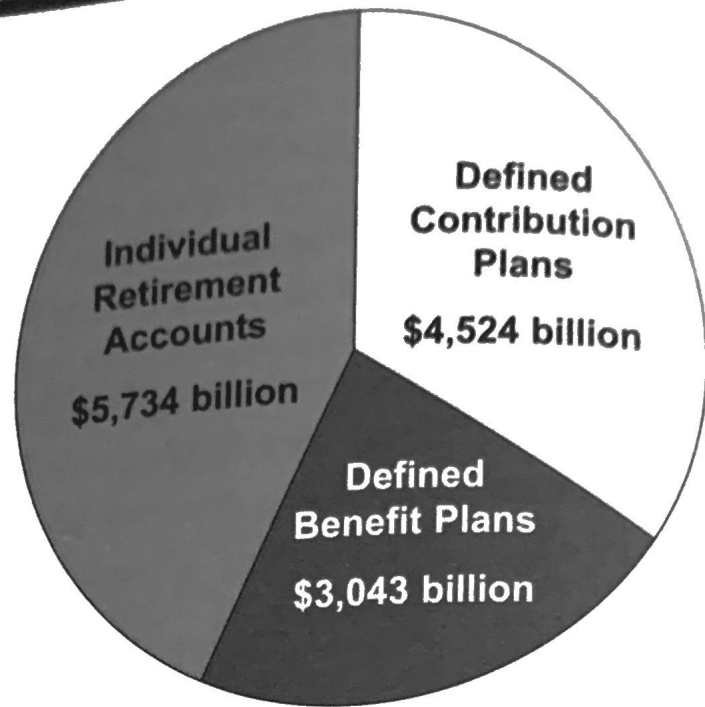
As more Americans age and retire, the ability of Social Security to provide the current level of benefits has been debated. Consequently, when planning for their retirement needs, adults of all ages should consider that Social Security benefits could be reduced in the future.

Although there are still some people who belong to **defined benefit pension plans**, the number is shrinking. More companies are turning to **defined contribution pension plans**, such as 401(k) plans (see exhibit 7.6, next page). Defined contribution plans put more of the responsibility on employees to contribute to the plan (although employers usually match employee contributions up to a certain percentage) and to manage the investments. Annual contributions up to a certain legal limit and earnings on those contributions are tax-deferred until they are withdrawn from the plan. Those who are self-employed can set up Keogh accounts that are similar to 401(k)s or IRAs for the self-employed called Simplified Employee Pension (SEP) IRAs.

defined benefit pension plan—A pension plan that guarantees the payment of a specified benefit at retirement.

defined contribution pension plan—A retirement plan fund that takes in employee contributions, which may be matched by employer contributions, and then invests the contributions into one or more investment alternatives determined by the employee.

Exhibit 7.6: Amounts Held in Private Pension Plans in the United States



Source: Federal Reserve, Financial Accounts of the United States, Third Quarter 2013, Tables L.118b, c, and L.225i

INDIVIDUAL RETIREMENT ACCOUNTS

Most banks and many financial institutions offer IRAs that provide tax advantages for retirement savings. Investment choices vary, depending on the bank. For many banks, IRAs are invested in time deposits, which often mirror a certificate of deposit. If a bank offers brokerage services or has a trust department, customers may have the option of investing in other types of assets, such as mutual funds or securities.

Contribution limits and eligibility requirements for IRAs are sometimes changed by federal legislators. The best source for confirming IRA limits and requirements is the IRS website where IRA contribution and deduction limits are posted for the current year. For example, in 2014, the maximum contribution limits for traditional and Roth IRAs combined is \$5,500 for individuals less than age 50 and \$6,500 for those age 50 or older.

IRA products are the traditional IRA, Roth IRA, SEP IRA, and spousal IRA.

Traditional IRA

The traditional IRA accumulates funds for use during retirement by investing in savings accounts, certificates of deposit, mutual funds, or securities. Taxes due on both annual account contributions (up to a limit) and account earnings are deferred until withdrawn. Penalty-free distributions (withdrawals) may begin at age 59½ but must begin by age 70½.

Roth IRA

Contributions to Roth IRA accounts are not deducted from taxable income, but there is no tax on account earnings. Certain distributions to the account holder or

beneficiaries may be made without tax penalty at any time. Unlike traditional IRA accounts, there is no requirement to begin distributions at any age. Exhibit 7.7 compares the traditional IRA to the Roth IRA.

SEP Plan

The SEP IRA is designed for the self-employed or small business owner. Employees do not pay taxes on SEP IRA contributions until they are withdrawn. Employers receive a business deduction for contributions made to SEP IRAs on behalf of employees. Employees set up the IRA to accept the SEP contributions. The contribution limits and eligibility requirements for SEP IRAs are different from those for traditional or Roth IRAs. For example, the maximum contribution limit, which is based on adjusted earned income, can be much higher than for traditional or Roth IRAs.

Spousal IRA

IRAs cannot be opened as joint accounts. Spouses who have little or no earned income can open a spousal IRA. A spousal IRA is subject to the same rules and limitations that apply to traditional and Roth IRAs.

ESTATE PLANNING

Estate planning—planning for the disposition of assets both before and after a customer's death—should be part of a comprehensive financial plan. Some states

Exhibit 7.7: Traditional IRA Versus Roth IRA

	Traditional IRA	Roth IRA
Contributions	Tax deductible Must cease at age 70½	Not tax deductible May continue for lifetime
Earnings	Not taxed until distribution	Not taxed
Distributions	Penalty free after age 59½ Mandatory at age 70½ Taxable as income	No specific age
Withdrawal penalties	Ten percent penalty for distributions before age 59½	No penalty for withdrawals if requirements are met
Eligibility	Fully or partially deductible subject to income limitations that phase out at \$70,000 (single) and \$116,000 (joint) in 2014, with income limits annually adjusted	Fully or partially deductible subject to income limitations that phase out at \$129,000 (single) and \$191,000 (joint) in 2014, with income limits annually adjusted
FDIC-insured	Yes for bank-deposited IRAs	Yes for bank-deposited Roth IRAs

probate—A judicial procedure whereby the validity of a will is proved and a decedent's estate, in accordance with a will if it exists, is administered.

Situation

Louise has been putting \$1,000 annually into a UTMA account for her grandson Sebastian, who is now in school. He plans to keep the money in the account until he finishes both college and flight school at the commercial pilot academy, at which time he will be 21 years old. Her grandson then plans to draw on the account to invest in a small local commercial airline company and establish himself in the business.

require decedent's assets of \$10,000 or more to go through probate, whether or not the decedent had a will. Certain assets may avoid probate, however, including:

- Assets owned jointly with a right of survivorship
- Life insurance, annuities, retirement accounts, and brokerage and bank accounts for which a beneficiary is named
- Assets in revocable living trusts

Objectives of estate planning include disposing of the estate's assets as the customer wishes, minimizing estate taxes and other taxes for both the customer and the customer's beneficiaries, ensuring security for the customer's family, and arranging for continuity of the customer's business, if applicable.

One savings product that is available to most customers is the result of the Uniform Transfers to Minors Act (UTMA), which replaced and continued the custodial account arrangement under the Uniform Gifts to Minors Act in 1983. Basically, a UTMA account may be used to make an untaxed transfer of assets to a minor, thus reducing federal income taxes on earnings from the assets. Legally, the account transfers to the child the responsibility of paying income tax, which would be taxed at the minor's tax rate. The account is managed by a designated adult (the custodian) until the minor is of age (typically 18 or 21 years old).

Trusts are another way to manage estate assets. Trusts may be used to:

- Build assets for a specific purpose or person through the accumulation of interest or dividends until the beneficiary reaches a specified age
- Receive the proceeds of an insurance policy for the benefit of minor children
- Give money to charity, either by providing a steady income or by arranging for income to go to another beneficiary, with the principal going to the charity after the designated individual dies
- Prevent irresponsible beneficiaries from squandering capital by allowing the trustee to distribute only interest, not principal

Estate planning requires expert advice, which bank trust departments can provide to customers who have specific needs regarding the management and distribution of assets.

TRUST SERVICES

Trust services complement other banking services and facilitate a total financial relationship with individual and business customers. To offer trust services, the bank's federal or state charter must accord it trust powers. Many banks in recent years have applied for and received trust powers so they can serve the growing wealth management market.



The trust structure has four components:

- **Trust**—The property (cash, stocks, bonds, real estate, or any other item of value) with which the trust is created
- **Trustor**—The person creating the trust
- **Trustee**—The person or entity that takes control of the trust property and administers the trust
- **Beneficiary**—The person for whose benefit the trust was established

When banks provide trust services, they act in a fiduciary capacity which, by law, requires adherence to fiduciary principles, such as acting in the sole interest of the beneficiaries, avoiding conflicts of interests, and carrying out duties with prudence, loyalty, and care. Banks, in their role as trustee, must observe the following fiduciary principles:

- **Prudent investor principle**—Banks are required to act with caution, skill, diligence, and a sense of responsibility. The standard is applied to the total portfolio, not to isolated investments, and to the overall investment strategy. The bank has a duty to diversify investments unless it is not prudent to do so. The bank must be loyal and impartial in how it delegates authority and selects supervising agents. The costs the bank incurs must be reasonable in amount and appropriate for the services provided.
- **Segregation of trust assets**—Assets of each trust must be kept separate from those of other trusts and from the bank's own assets. Trust departments usually are segregated from the rest of the bank, with their own vaults, data processing equipment, and other facilities. Many banks use outside investment advisors to manage trust accounts.
- **Prevention of conflicts of interest**—Banks should have no interest whatsoever in the investments bought or sold for trust funds. The bank should not purchase or benefit in any way from property or other assets held in trust.

Depending on market needs and business volume, banks may offer personal trust services such as estate settlement, trust administration, guardianships, and personal agency services.

ESTATE SETTLEMENT

When a customer with a trust dies, a trust officer will help settle the decedent's estate. Outstanding debts or taxes may need to be paid, and the estate assets distributed to the decedent's heirs.

A trust department's estate planner advises customers to have a valid will that describes the property owned and its location. The will should designate the beneficiaries to whom the property will be left and the person or entity (such as the bank) that will carry out the terms. That person or entity is referred to as the **executor**

*"Put not your trust in money,
but put your money on trust."*
— Oliver Wendell Holmes

executor—A party, often a bank, trust company, attorney, or even an heir, who is appointed in a will to carry out the terms of the will.

intestate—Derived from the Latin word *intestatus*, meaning one who dies without having made or left a valid will.

or, in some states, the personal representative. The executor may be a relative, friend, beneficiary, bank, lawyer, or some combination of these.

If the decedent did not leave a will, or if the will is not valid, the decedent is said to have died **intestate**, and the estate is distributed in accordance with the laws of the state. The probate court appoints an administrator to carry out the terms of the will if the executor cannot or will not serve and the will is valid. Basically, the duties of executors and administrators are the same. They include:

- Taking inventory to determine the exact value of the estate, and itemizing and showing a dollar value for each of the decedent's assets
- If necessary, taking control of some or all of the assets
- Filing notice in a newspaper or other medium of public circulation requesting submission of any claims against the estate
- Filing federal and state tax returns and paying all taxes on the basis of the estate's value
- Settling all debts and claims against the estate
- Preparing a final accounting of the estate for the court
- Distributing the remaining assets, either according to the terms of the will or as directed by state law

When a bank acts as administrator or executor, by law, it must keep detailed records and is accountable to the court and beneficiaries for its actions.

Situation

Adam, a retired businessman, wants to revise his will. Ten years earlier he had named his son as executor. Since that time, however, his assets have grown considerably, and he has acquired works of art and real estate. Although he still wants his son involved in the settlement of his estate, he feels his son would benefit from the services of a professional as well. He solves this problem by naming his son and his bank's trust department as co-executors in his will.

TRUST ADMINISTRATION

Trust administration services are for bank customers who seek professional management of their assets to ensure financial objectives are met, beneficiaries are provided for, and trust assets are distributed to heirs. The most common types of trust funds administered by banks are testamentary trusts, living trusts, and charitable and institutional trusts.

- **Testamentary trust**—A trust established under the terms of a decedent's will. As trustee, the bank is responsible for managing assets turned over to it by the executor or administrator and for making payouts to the beneficiaries as specified in the will.
- **Living trust**—A trust created by living individuals who execute a trust agreement and transfer property to the trust. Individuals often want to avoid the details of probate or keep the transfer private. Sometimes individuals no longer wish to manage their affairs because of illness, extensive traveling, or lack of financial expertise. The trustee then manages the trust's assets.
- **Charitable and institutional trust**—A trust set up by an individual to benefit a university, hospital, or other charitable organization. Sometimes the beneficiary may make the actual arrangements for the trust on behalf of the individual. The trustee then manages the trust's investments.

GUARDIANSHIPS

A guardianship (sometimes called a conservatorship) is established by court order for the benefit of a minor or incapacitated person, known as the ward. A bank trust department often is appointed to manage the property for the minor or incompetent person. To prove that all the proceeds are being used for the person's benefit, the trust department periodically provides an accounting to the court.

PERSONAL AGENCY SERVICES

Bank trust departments may offer agency services, which by law, differ from trust services. Whereas trustees assume legal title to property turned over to them, agents do not. Instead, an individual who retains legal title to the asset gives specific authority to the agent. However, as with a trustee relationship, a bank functioning as an investment advisor or agent must act in accordance with fiduciary standards. Safekeeping, custody, investment advice, and investment management are the most common agency services banks provide to individuals.

- **Safekeeping**—The bank accepts, holds, and on request, returns stocks, bonds, or other assets to the customer.
- **Custody**—The bank holds assets in safekeeping and collects income. Custodians buy and sell securities when specifically instructed to do so by the customer or an appointed agent. Banks provide custody services for individuals, correspondent banks, and government agencies.
- **Investment advisor**—The bank performs the duties of a custodian plus other responsibilities granted to it by the individual. When handling securities, the bank may review investments and suggest the retention, sale, exchange, conversion, or purchase of new securities. As investment advisors, banks may handle real estate. The bank may act in an agency capacity to collect rental income, pay property taxes, arrange for property upkeep and maintenance, and disburse any net income as directed by the owner.
- **Investment manager**—The bank, acting as investment manager, also may make financial decisions on the customer's behalf, based on previously established investment criteria.

LAWS AND REGULATIONS

The banking industry is authorized to offer a full range of financial services as a result of the enactment of the Gramm-Leach-Bliley Act (GLBA) in 1999. The law was designed to modernize the nation's financial system and put banks on a more competitive footing with other types of financial service providers. The primary vehicle for reform is the financial holding company, which can engage in any activity that is "financial in nature," including underwriting and selling insurance and dealing in securities. Banks may also petition for the authority to engage through a nonbank affiliate in any financial activity that is not specified in the GLBA.

The GLBA established a **functional regulation system** that applies to all traditional and nontraditional products and services offered by banks, including insurance, investments, IRAs, and trusts.



Did You Know —

Sixty-one percent of Americans do not have a will, leaving them at risk of dying intestate and leaving it up to a probate court to determine how their estate will be distributed. In addition, 70 percent of Americans with children under 18 in the household have no will, putting their children's future at risk.

Source: Harris Interactive, April 2013 poll

functional regulation system—A regulatory principle incorporated in the Gramm-Leach-Bliley Act that requires certain authorized banking activities to fall under the authority of federal and state regulators other than the principal federal bank regulators (this was somewhat modified by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010).

Situation

Monica creates a living trust in which she places \$300,000 worth of stock. The dividends are to benefit her oldest son, who is disabled. The trustee is a long-time friend of the family. In her will, she also creates a testamentary trust into which all her assets will go at the time of her death. Income from the trust property will be used to support her husband. At his death, the trust will be terminated and the assets divided among all her children. The trustee for this trust is the family bank.

The following are examples of laws and regulations applicable to trust and investment services.

RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

As discussed earlier, investments such as stocks, bonds, annuities, and mutual funds are not bank deposits and, therefore, are not FDIC-insured. Bank regulators recognized the need to protect bank customers who were purchasing these products. In 1994, the regulators issued an Interagency Statement on Retail Sales of Nondeposit Investment Products, which emphasizes that banks must disclose to customers that these products are not FDIC-insured. Banks selling investment products must take several precautions, including:

- Marketing nondeposit investments in a manner that does not mislead or confuse customers about the products or the risks, such as by separating retail deposit-taking and retail nondeposit sales functions within the bank
- Prohibiting bank employees, such as tellers, from offering investment advice
- Refraining from offering uninsured retail investment products with a product name identical to the bank's name
- Conspicuously disclosing that investment products are not FDIC-insured, are not obligations of or guaranteed by the bank, and carry investment risk and possible loss of principal

CONSUMER PROTECTION IN SALES OF INSURANCE

In 2001, the federal banking regulators issued regulations under GLBA that apply sales disclosure and practice rules to retail sales of insurance products sold for personal, family, or household purposes. The requirements are similar to those established in the interagency statement on nondeposit investment products. Basically, customers must be made aware that insurance products are not FDIC-insured. The disclosures must be given both orally and in writing, and consumers must acknowledge their receipt in writing.

UNIFORM TRUST LAWS

Historically, laws governing the creation and administration of trusts have been implemented at the state level. However, in 2000 the Uniform Law Commission (then known as the National Conference of Commissioners on Uniform State Laws) moved to address the differences among states by creating and offering a uniform set of rules, known as the Uniform Trust Code (UTC), that states could use as a model for their trust laws. By offering a set of basic rules that govern voluntary trusts, the Uniform Law Commission helped create some uniformity in how trusts are governed. To date, more than one-half of the states have substantively adopted the UTC, and several more state legislatures have introduced it for enactment.

Other uniform rules apply to trusts as well, although differences among states remain. Examples include:

- **Uniform Probate Code**—Pertains to the succession of property at the time of an owner's death, as controlled by the will, intestacy statute, and the probate process
- **Uniform Prudent Investor Act**—Provides rules for investing trust assets by requiring trustees to apply modern portfolio theory to investment decisions and to invest as a prudent investor would; namely, taking into account the purposes, terms, distribution requirements, and other circumstances of the trust and using reasonable skill and care
- **Uniform Principal and Income Act**—Sets forth rules for allocating a trust's principal and income, apportionment of income, the right to payment, and the trustee's powers to adjust principal and income with regard to prudent investor obligations and other duties

SUMMARY

- The financial status of U.S. households today is a matter of concern. The recession of 2008-2009 lowered the personal net worth and delayed the retirement plans of millions of Americans. Since then, savings rates have rebounded but still have not returned to what they were in past decades. In response, government, industry leaders, educators, and consumer interest groups have joined forces at the grassroots and national levels to educate Americans of all ages on the value of and methods for obtaining, maintaining, and restoring financial health. Banks play an important role in this effort by providing personal wealth management services from the most basic financial planning information to more complex high-end trust and investment services. In doing so, they fulfill their fiduciary role as trustworthy financial resources.
- Financial planning is the development and implementation of a plan to achieve a person's overall financial goals, including maximizing income and minimizing expenses to achieve both short- and long-term objectives. The financial planner advises customers with regard to their financial decisions and helps customers coordinate the work of specialists such as accountants, brokers, lawyers, and insurance agents. Because financial planners are generalists and not specialists, they must be careful to avoid the unauthorized practice of law. Financial planners, however, can inform customers about the tax-deferral and other features of products they are considering for their financial plan.
- Financial planning should be tailored to the age of the client. For example, the financial needs and goals of young adults differ from those of adults with children or empty nesters. Financial planning thus begins with an appreciation of the customer's life stage and present financial situation and then continues with an analysis of such factors as inflation, the time value of money, and the risk-reward factor for each asset and investment choice. Net worth is calculated and a cash flow strategy drawn up. The customer and the necessary experts put the plan into action and then reassess the plan, usually annually, for needed modifications.

- Many banks now offer noncredit-related insurance products, including life, health and disability, long-term care, property, and liability insurance. Two general life insurance categories are term and whole life. Banks also offer credit life insurance to pay off an insured's loan in the event of death. Property insurance protects the value of anything consumers own that might be lost due to fire, theft, lawsuits, or other events. Title insurance protects homebuyers from losses due to questions about the ownership of the property. Vehicle insurance policies provide liability coverage and optional collision coverage.
- Bank subsidiaries or holding company affiliates may offer investment and brokerage services through third parties and joint ventures or as an in-house function. Banks must fully disclose that these products are not FDIC-insured. Whatever the investment strategy—conservative, moderate, or aggressive—diversification usually is recommended.
- Stocks, bonds, mutual funds, and annuities are the most common investments used in financial plans. Whatever types of investments a customer chooses, the portfolio should be evaluated regularly to ensure that the results meet the goals set out in the financial plan, including diversification. Banks also offer portfolio management services such as asset management and trading accounts.
- Retirement planning must take into account increased life expectancies. Many people will receive Social Security benefits, some will receive pensions from defined benefit plans, and many will receive income from defined contribution plans, such as 401(k) and Keogh plans. Most banks today offer traditional, Roth, and SEP IRAs.
- An estate plan prepares for the disposition of assets both before and after the customer's death. The objectives of estate planning include ensuring that the right people receive the right assets and that taxes are minimized for both the customer and the customer's beneficiaries. One savings product that is available to most customers is a Uniform Transfer to Minors Act account that can be used to make an untaxed asset transfer to a minor, thereby reducing federal income taxes on the asset's earnings.
- Trust services complement other banking services and facilitate a total financial relationship with individual and business customers. The trust structure has four requirements: the trust, the trustor, the trustee, and the beneficiary. As trust service providers, banks act as fiduciaries and must abide by the prudent investor principle, segregate trust assets from bank assets, and ensure against conflicts of interest. Trust services provided by banks to individuals include estate settlement and the administration of testamentary trusts, living trusts, and charitable and institutional trusts. Trust departments also provide guardianship and personal agency services, including safekeeping, custody, investor advice, and investment management services.
- While the GLBA allows the banking community to offer products that were previously off limits, such as insurance and investment services, banking laws and those pertaining to other specialized areas still apply certain limitations and requirements. Examples include the sale of retail nondeposit investment products and consumer protections regarding the sale of insurance. The uniform trust laws also impose principles and requirements on bank trust services in the states where the laws have been adopted.

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