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THE CHANGING ROLE OF THE FAMILY OFFICE

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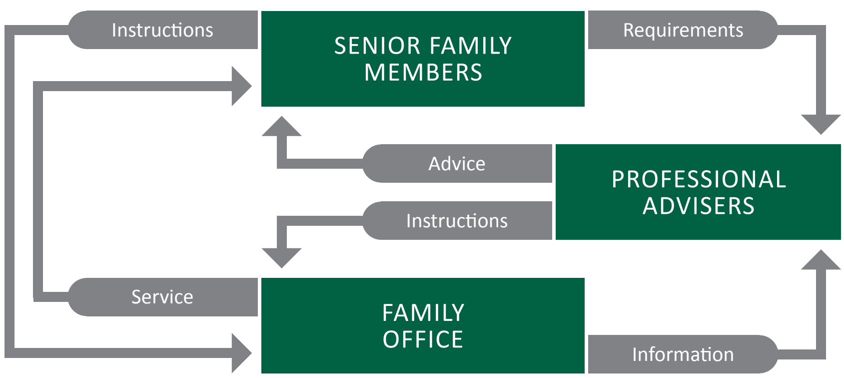
Family offices are struggling to cope with the growing demands for advice and expertise arising from increased regulation, a more litigious society and the risks of an unstable global economy. Andrew Nolan argues the need for tighter definition of its role and responsibilities to enable the family office to adapt to the current environment

There is no blueprint for a family office, as each should be designed to serve the particular needs of the family concerned. There have, however, been some clear trends over the last two decades which need to be considered by any family establishing a new family office or reviewing the role of an existing one. Indeed the extent of the changes now taking place in the external environment is challenging the fundamental concept of a modern family office and its economic viability. Never before has it been more important to define the objectives and to design a working model which can realistically meet those objectives in a cost efficient manner.

THE TRADITIONAL FAMILY OFFICE

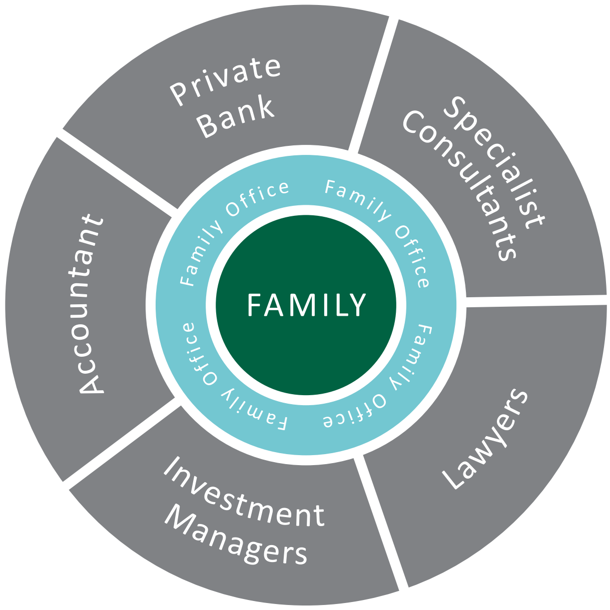
Whilst a family office should in theory be 'purpose built', most have evolved over decades, new functions being added on in response to events. Many started as offshoots of a family business or an estate office.

The role was primarily administrative, keeping accounts, processing transactions and administering trusts and other vehicles. The family would take advice directly from professional advisors such as lawyers, accountants, stockbrokers and land agents and the family office would be responsible for implementing that advice.



EVOLUTION FROM ADMINISTRATOR TO ADVISER / GATEKEEPER

Over the last twenty years, the role has gradually evolved from administration and implementation to adviser and 'gatekeeper' between the family and their professional advisers.



There are four main reasons for this significant change of role:

1. The need for professional advice is more frequent and more specialised, reflecting an increasingly complex and litigious environment. Many families require a 'gatekeeper' to identify issues, to select appropriate specialists, to understand and interpret the advice they give, and to integrate that advice into the broader picture.

2. Wealth management, in particular, is vastly more complex than twenty years ago with a plethora of new products, strategies and structures, which require extensive analysis and ongoing monitoring, to ensure the right solutions and the right advisers. The days of relying on a single stockbroker or investment manager are now a distant memory.

3. The increased risks of a fast changing and unstable economic environment have brought a need for highly sophisticated risk management across the full spectrum of family finances.

4. Families themselves have become more complex, primarily because they are increasingly international, but also because many have multiple business interests

THE PROBLEM WITH THE CURRENT MODEL

The problem is that the need for advice is growing so rapidly that it is challenging for a typical family office even to meet the requirements of being an effective gatekeeper.

The combined impact of ever more complex tax compliance, increasing regulation and a highly litigious environment is testing the capabilities of even the largest and best resourced family offices. Many indeed are so busy responding to the latest tax or regulatory changes that they scarcely have time to consider the bigger picture, especially family strategy, governance and succession planning.

The problem is often exacerbated by loose definition of the role of family offices, causing muddled thinking and duplication of effort between the family office and external advisers. Some family offices, for instance, have already overreached themselves in trying to duplicate the role of an external asset manager, without the critical mass or resource to deliver a fully competent service. Not only is this inefficient, but by immersing themselves in excessive detail in one aspect of the family's affairs, they can be distracted from their core responsibility of implementing the family's wider wealth strategy.

Defining what is expected of a family office can be more difficult than it sounds, as it involves articulating very precisely the relationship between the family, the family office and external advisers, both in reaching decisions and in the implementation. It will involve analysis of:

1. The family itself

2. Key areas of collective activity

3. Extent to which the family wishes to delegate the management of its wealth to a family office, rather than through direct relationships with professional advisers and private banks

1. THE FAMILY HISTORY AND CIRCUMSTANCES

Whilst each one is different, the services required will strongly reflect the circumstances, size and history of the family itself:

- History, number of generations and number of family members
- Ability, orientation and authority of family leadership
- Geographic and jurisdictional complexity
- Assets collectively owned / collective activities
- Complexity of structures through which assets held
- Family strategy, objectives and values
- Family Governance

Clearly it is a very different proposition to run the family office for a 1st generation entrepreneur with two young children than for a 5th generation family with 200 members scattered around the world, led by senior family members who are not particularly interested in business and are thus less involved in day to day decisions.

Equally, the role of the family office is strongly affected by the complexity or otherwise of the structures through which the assets are held and the governance framework which aligns family decision making with long-term strategy and objectives. The family office is often the guardian of family governance processes and in larger families, with many different trusts and companies, it requires considerable skill and experience to ensure key decisions reflect the interests of the family as whole.

2. MAIN AREAS OF COLLECTIVE ACTIVITY

The priorities of the family office will also reflect the main collective activities of the family which will generally include some or all of the following:

- Investment management, banking and treasury
- Relationship with family business
- Private equity and direct business interests
- Property
- Philanthropy
- Administration (Basic / Expert) and Reporting

In each area, the precise role of the family office needs to be defined, for example:

Investment management

How is responsibility for asset allocation and manager selection apportioned between external investment managers, the family office and the key decision makers within the family? Is the role of the family office to be a manager of managers and supplier of investment services or to stand in the shoes of the family in purchasing such services from the external market?

The difference may be subtle, but if not precisely defined, there is every chance the family office will become a shadow investment manager, with all the resource and cost which that implies.

Relationship with Family Business

To what extent is the family office involved in overseeing the relationship between the family business and family shareholders (often through trusts and other vehicles), ensuring that the interests of all shareholders are properly represented, especially when major decisions are made which impact on the risk profile of their investment?

In many cases the family leadership is directly involved in the business, so knowledge and skill may be required in ensuring their decisions are subjected to proper scrutiny on behalf of other family members. The family office may also be closely involved in succession planning for the business, often through a formal framework defined in the family constitution.

Private Equity and other business interests

Is the family office a mini private equity house accountable for performance or does it simply implement the ideas and decisions of senior family members to invest in private businesses on an opportunistic basis? If the latter how are the interests of other family members protected?

Again, the difference is quite fundamental, one requiring a team of highly experienced private equity professionals, and the latter requiring someone with sufficient corporate finance experience to research and implement, but not ultimately responsible for decisions. Either way, suitable governance will be required to protect the interests of the wider family.

Property

Is the property for residential, leisure or investment purposes or a combination of all three? Does the family office find and negotiate the purchases on the family's behalf, or does it simply implement the instructions of the family and provide ongoing administration services? Is it also responsible for considering the tax and succession implications and the alternative structures through which the properties should be held?

Philanthropy

Is there a philanthropic legacy and what are its objectives, both externally and within the family? What role do the family members play in this and what support is required from the family office?

Arrangements for philanthropic giving vary considerably from one family to another, but philanthropy is increasingly combined with succession planning in leaving a legacy of social capital as well as monetary wealth, in which family members play a key role.

Administration and services

The administration requirements of a family office can require considerable technical expertise (trusts, tax, legal, banking etc) and a deep working knowledge of the family is also essential, including the history, personalities, preferences and objectives, so that the family office is able to process routine transactions without continuous reference to the family leaders.

Just how complex are the family's requirements and what is the frequency of transactions requiring decisions and judgments in the implementation? Are they, for instance, frequently buying properties, works of art or leisure assets? How complex are the banking and treasury arrangements?

Legal, structuring and tax issues

All of the above are overlaid with legal, structuring and taxation issues, some of which may be relatively routine and within the competence of the family office team, whilst others may require specialist external advice. For complex situations even quite routine transactions may have significant ramifications which need to be considered.

Risk management

Finally, risk management for a wealthy family now requires a highly disciplined methodology similar to that for a business. It starts with a full risk audit, analysing and prioritising all the risks faced by the family, across all the assets including direct business interests, as well as the investment portfolios and the risks in the family itself.

3. THE NATURE AND DEPTH OF FAMILY OFFICE INVOLVEMENT

To address the role of the family office from a slightly different perspective, it is worth asking in principle what level of advice and service the family requires:

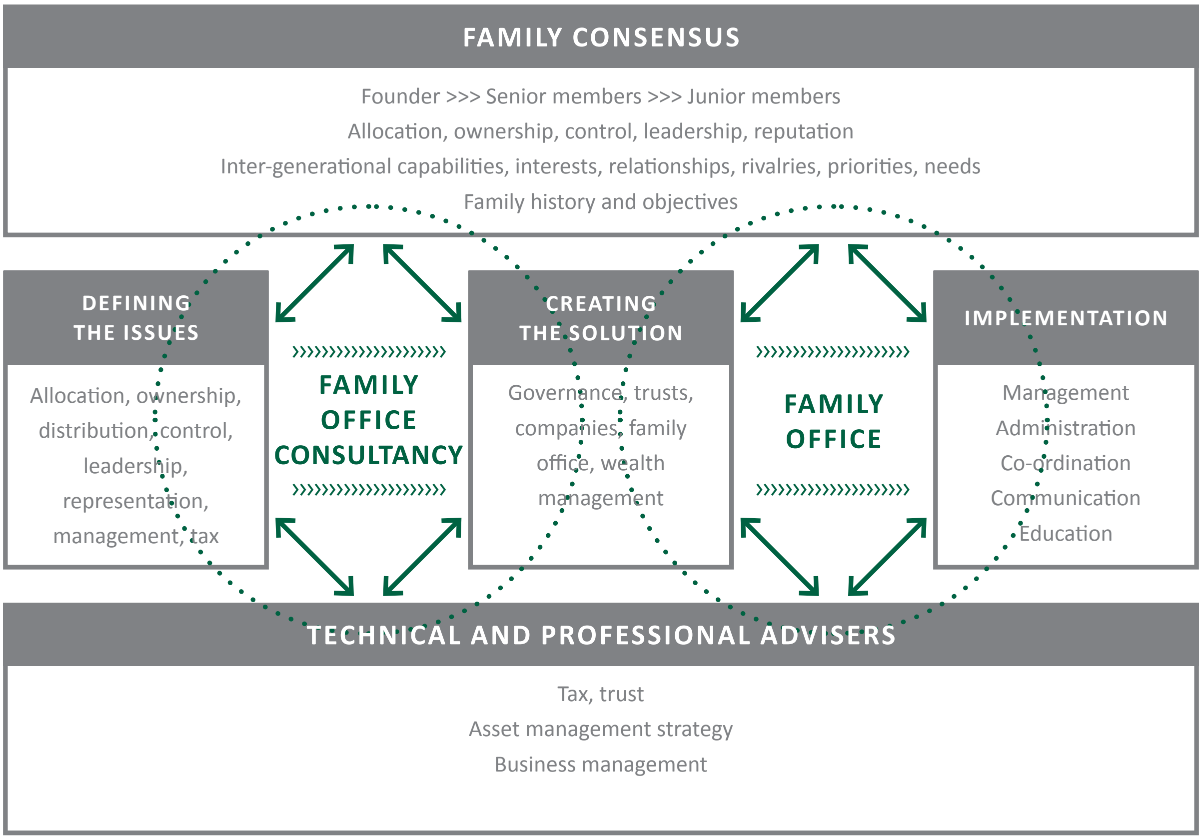
A. Implementation and administration only - family make key decisions with direct input from advisers

B. Family Office selects and coordinates external advisers

C. Family Office plays lead, trusted adviser role

D. Family Office sets agenda for family and plays leading role in facilitating decisions

At the extreme, the role of the family office combines that of a service provider, trusted adviser and management consultant, working with a range of professional advisers to identify the right course and build a family consensus, as well as being responsible for implementation and administration.



In practice the level of input may vary as between the different areas of responsibility. For instance a business family may want the family office to have limited involvement with the family business, but a much deeper level of involvement with the investment portfolio.

The nature and depth of involvement may also change over time, particularly as the family leadership passes from one generation to the next. The family office may have a role to play in preparing for that transition and for succession planning more generally.

Some family offices are led by one or more family members, although this obviously depends on having someone willing and able to fulfil that role, who is competent, acceptable to other family members and willing to submit to proper governance processes.

KEY CONCLUSIONS

First, it must be accepted as a fact of life that the world is changing and that wealthy families will probably pay more tax than in the past and incur greater costs in managing their affairs, if they wish to avoid unnecessary risks. Unpalatable though this may be, they have to be realistic and can only set out to manage their wealth as efficiently and effectively as possible.

Second, in order to contain these costs, the objectives and role of the family office must be much more precisely defined than in the past, clearly specifying the division of responsibilities between the family, the family office and external professionals such as investment managers and lawyers. Improved definition reduces unnecessary duplication and time wasting caused by indecision or muddled thinking.

Third, for every significant activity (including high level strategy), the optimal balance must be found between the expertise and servicing capability to be maintained within the family office and the extent of outsourcing to external specialists. This balance will depend on the volumes and complexity of the anticipated work and the impact on quality as well as cost.

Fourth, considerable thought needs to be given to the need for a trusted adviser to the family and whether this advisor resides in the family office. Having such an individual regularly involved at the heart of the family's decision making may not only improve the quality of key decisions made, but also save considerable costs by swiftly rejecting ideas which are unlikely to be viable, before too much has been invested in their appraisal.

Finally, the model for any family office must be realistic in terms of the ability to recruit, retain and motivate suitable staff, bearing in mind that whilst there are benefits of having advisers directly employed, these must be balanced against the benefits of using external advisers who have regular and ongoing experience of working with other clients in their field of expertise.

FOR MORE INFORMATION

Andrew Nolan
Partner - Head of Family Office

Andrew is Head of our Family Office Division. For over 15 years he has helped families around the globe deal with the complex day-to-day challenges of succession, governance and wealth transfer. He chairs several family councils and also serves as a Key Adviser to a number of high net worth families.

Andrew joined the Stonehage Fleming Group in 1997 and was Head of the Neuchâtel and Zürich offices from 1998 before moving to the London office in 2012. He is a Chartered Accountant and has a BA (Hons) in Economics from the University of Nottingham.

enquiries@stonehagefleming.com
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