

Governance in family offices - Part 2

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Welcome to the second part of our series on governance in family offices. In the second part of our video series, we're going to take a more detailed look at why governance matters in family offices.

We'll take a look at some of the issues involved in developing it, maintaining it, and how it can help in the continuity for family offices and for family wealth.

What style of family governance is best to undertake?

Russell

The question about the nature or the style of governance in the family office is a really good one to ask. To help to understand the answer to that question, I think it's quite helpful to go back to the basic reasons why a family office is established in the first place.

If you think about why and how many single families are set up, it is often because of a big business transaction or a liquidity event that releases a lot of capital for a family. And then the principal decides to get organised in the form of a family office and very often, they will then rely on the staff that they were using in their business life to help them set up the family office. And in a sense what you have is a set of relationships in that family office, a governance model in that family office, that is based on trust, on knowledge and familiarity with those people.

And I think that's why what we describe as trust-based forms of governance in family offices often are the first things we encounter. Now, clearly that sort of trust-based model can continue for a number of years and I think for many family offices that are using that form of governance, it's based on the, 'if it ain't broken why change it?' sort of model, but I guess they won't last forever.

Aside from unfortunate and untimely events, there will be the natural transition within the principal, within their family, and within the family office. There may be growth of the wealth, there may be growth of the family. So, it's also right to prepare yourself for the future circumstances that the family and the family office will face.

So, I think one of the critical things that we see is when do families choose to make that proactive change, from a trust-based model which can work perfectly well for them, to a more formal form of governance? Now that issue that we've talked about - flexibility and agility - is often seen as one of the reasons not to move forward. Whereas I think what we ought to be focusing on is the issues around management of risk, governance and oversight as being the good reasons, particularly in a growing family office or in a more complex family office environment, as to why a more formal form of governance should be thought about.

Andra Ilie

I was smiling because it made me think of you know, my own family and in general, I think if people think of their own families, who has formal rules you know, how do you interact with your brothers and sisters? You don't really need something formal. You're not going to have something that you write on and put on the kitchen wall for everybody to know what they do. However, also on the other side, how good would it be if you had those and if everybody knew their role? A bit like a rugby team or any other sports team; if people knew their positions and their roles and responsibilities and where the boundaries are. I think that would make everybody's lives much easier and the same applies to family offices.

Russell

No, I agree, and I think if you then reflect on some of the counterparties the family offices will deal with; external organisations. If you think about the number of legal entities that they're managing very often in these family offices with that sort of almost, sort of corporate governance style of governance requirement, then I think we really do begin to ask the question: why isn't there more formal governance? I think you're absolutely right though, the issues around family and governance is a much more tricky issue for people to move forward with.

Andra

Absolutely, and I think the difference lies where emotions come in and sometimes overtakes reason.

For what reasons would families shy away from implementing governance mechanisms?

Russell

If we take a slightly deeper look at the issue of why certain families and family offices don't implement a more formal approach to governance, I think it hinges on a couple of factors. The first of those is that family offices are, and it's inherent in the name, about family. Whether that's the actual family itself or the family office, it's a very closed environment. So, if we think about the owners, the principals, the funders, the beneficiaries and very often the number of the staff inside the family office, they can all be family members.

So, I think given the nature of the family relationships, to then bring in a more formal mechanism for governance can seem quite alien. And the second reason I think that there is a, if you like, a sense of not introducing formal governance in family offices, it's a lot to do with where the, if you like, the set-up comes from, those business owners for whom actually, agility, freedom of decision-making, entrepreneurialism, all of those elements were a key part of how

the wealth was formed in the first place. So, to switch from that into a more formal mechanism, again I think can be quite alien.

And so, for me it's a question of helping people to understand when is the right time and how you should move seamlessly, in a way, through that process of going from less formal to more formal forms of governance.

Andra

I completely agree. And I think also the fact that there is no regulatory requirement per se in the UK, and in most jurisdictions really, there isn't anything to do with the governance of how family offices run I think that adds further pressure onto it.

So, I mean, we also discussed... You mentioned earlier that family offices can take many structures and come in different types. So, in the UK alone, we may have the UK corporate governance code, but even that it's not legally binding, it's a complier explained type code. We then have things like the waste principles for like the larger privately-owned businesses. But there is nothing specific for family offices and therefore, you know, people might not feel like there is an incentive to follow them.

Russell

And I think sadly we've also seen some situations that have been well known and well reported on where actually there have been problems inside family offices. But again, we've also seen examples where clients of our own who've set up family offices some years ago, have then decided now is the right time to revisit their governance. And for some of course, we've seen a situation where their family office has grown to such a scale, they're even asking themselves the question: do they really know what's going on inside that family office? Have they got the risk management, reporting, and control mechanisms where they can be assured about what's happening?

What are the key areas families should focus on in creating effective family office governance?

Russell

If we think about the areas in which a family should think about when looking to create effective governance in a family office, clearly much will depend on where they are on their journey.

Being right at the outset of setting up a family office is clearly very different from having had a family office for some years or indeed for many years. But I think there is a simple mechanism that we use when we're discussing this with our clients and families to help them think about this in three simple steps, and they are: purpose, people, and process. And I'll just run briefly through what we mean by each of those.

So, when we talk about purpose what we're really saying is: What is the purpose of the wealth for the family, and what is the core purpose that the family office is going to perform for that family? Understanding in very clear terms both of those things then helps you to describe: what is the scope of the family office?

And once you understand what the scope of the family office is in the relationship with the family and the wealth, you can then begin to put in place the governance mechanisms that will help you to sustain those two purposes.

The second of the topics that we would focus on is people. And when we think about the topic of people in relation to governance, it's quite an interesting one because I think when most people think about the topic of governance, they're thinking about rules for decision-making, for structures and things like that.

But when I think about governance and people I also think about the behaviours of the people. Because the simple truth of it is you could have the best set of rules in the world, but if you

don't have the right set of behaviours to go alongside those rules, well, you will end up with a very interesting situation. So, the issue of people in relation to the governance in a family office, I think is really important.

So, just to take one view of that; if we look at trust-based governance mechanisms, clearly that's all about the behaviours. If we think about the more formal ones, it's not saying, 'you have to take away the focus on behaviours'. It's just saying you support those behaviours with a clear set of guidelines and rules.

The issue for me is what happens if the trust breaks down. Now that trust can break down for very unfortunate reasons, like a falling out between people, but it can also happen because of natural reasons, like succession. So, if there is a succession issue in the family or the family office, that trust automatically falls away and would have to be rebuilt - and that's no easy task. So, I guess one of the key reasons we focus on people, the people issue around governance, is to ensure that you don't have that sort of cliff-edge issue around trust-based governance.

Andra

And I suppose this is actually an example that we were talking about recently with the next generation coming into the family office. So, introducing yet another set of challenges, another dynamic, another outlook, again brings back the point that you are making around the importance of having some sort of an infrastructure around people.

Russell

You're absolutely right Andra, and it's not just about the next gen. It's also about anybody new coming into a family office environment, whether that be the next gen or an external professional that's being hired. It's so much easier if they come in and understand the framework for governance in that family office. It's really hard to come into a trust-based environment.

Andra

Absolutely, one of the families I believe that we were talking about, was saying that, you know, having a clear set of rules that they shared, makes those that the rules are shared with, feel part of it.

Russell

And then finally, the third area is that of process. And what we mean by process is a really clear understanding of just exactly how everything in the family office operates. Clearly it goes back to the topic of scope; if you know the scope, you know what processes you need to have. But it's also about thinking about the control arrangements, it's thinking about the management and reporting arrangements, and ultimately the governance and oversight. And I guess what we would say is: For any family office, trust-based or otherwise, understand exactly what the key processes are that underpin the point and purpose of the family office because again, then you've got a very clear framework to help those that are in the family office and actually in the family.

What are three steps clients should consider if wanting to take action?**Andra**

So, using purpose as an example to continue what you were just mentioning; is the family office still in line with a family's expectation? So many people say that a family office is an extension of the family, so does it still serve it well? Has another generation of either advisors or next-gen family members come in, and are their wishes the same?

Secondly, I would say conduct a review of the risks and controls around the family office. And again, this is something where management should be informed; they should be aware of what these are, how these assessments have been undertaken, what controls are in place.

So, to use an example, again going back to something you mentioned earlier, Russell, the piece around portfolio risk. So, things such as concentration or liquidity risks: what are we doing about it in the family office? And, at the other end of the spectrum, when we look at controls; simple things such as payment controls; you know, who signs off for that? Or IT security, you know, a lot of the families are talking to us about the risks of cyber fraud.

Russell

And I think in addition to that, Andra, it's also worth thinking about not only what's going on inside the family office in terms of the controls, but also how that control environment relates to the family itself. Do the principals in the family have the same sense of assurance about the control environment that the family office team do?

Andra

And perhaps the third step that family offices could take is very much - I know it's your favourite topic - the 'what if?' analysis. So, having a think about those big situations, the elephant in the room, or elephants, in many cases, and what can they do about it?

So, to give an example: one of our recent cases, where the family office was an embedded type. The individuals that were taking the decisions – the key decision-makers – were not employed and no sort of authority to make any sort of decisions. Now all is well whilst the principal is still there and has signing powers over everything. However, 'what if?'; what if he's not here? What if he becomes incapacitated and there's things such as Power of Attorney, and things like that, that we spoke to the clients about. But it's scenarios like that and just being prepared for the unexpected.

Russell

And I think you highlight a number of really good points. And on top of that I think it's important, regardless of the length of time that your family office has been in case, and often

actually, it's even more important where it's been a long-standing family office arrangement, to really look hard at those three things you've mentioned.

What are the three key takeaways?

Andra

Our three key takeaways for today are: firstly, I think family offices are becoming increasingly complex and this is due to a combination of factors including increase in oversight and regulation.

This then in turn places pressure on trust-based governance approaches and prompts the need for more formal governance in family offices.

Finally, I think fundamentally, family offices should be regarded in the same way as businesses. So, if you're an entrepreneur building a business and for that you're creating a proper level of governance, a proper business plan and everything, why would you not do the same for your family office?

Russell

I absolutely agree, and while that governance should be based on sound principles, I think we also need to recognise that it shouldn't get in the way or dampen that entrepreneurial spirit that so many people setting up family offices have, and also that agility and flexibility, that the very concept of a family office brings.