

# Risk Management for Financial Families

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# Risk Management for Financial Families

## Introduction

For years, families of significant wealth and their advisors have limited their definition of risk management to the traditional dimensions of investment performance and insurance risk. However, discussions of family wealth and investments within these traditional dimensions of risk management fall short of providing the sense of security wealthy families seek in managing and preserving their wealth for future generations. For this reason, owners and advisors of wealth must recognize that a larger, more comprehensive view of risk management is necessary to preserve assets—human, intellectual, social and financial—for multiple generations.

## Why Wealthy Families Need Risk Management

To become an enduring financial family,<sup>1</sup> owners of wealth and their advisors must ensure that asset and risk management decisions are made with the complete understanding of what the family values, has at risk and how those risks can be managed. It is only from this perspective that families of wealth can position themselves for decision making that is better than that of the average investor and that likely will provide better-than-average results.

After interviewing more than 500 families of wealth, the Family Office Exchange (FOX) identified the four most important factors in determining the success of a financial family:

- How the family defines shared ownership goals and its future together.
- How well the family identifies and mitigates family risks.
- How well the family manages transitions.
- How the family reinvests its human, social and financial capital.

All four factors are critical; but the first two— identifying family goals and recognizing and actively managing shared risks—are of particular importance. The interrelationship between these first two factors will often serve as the barometer for a wealthy family’s future decision making. Recognizing and agreeing upon family goals collectively will help a family of wealth to stay together and maintain control of both its tangible and intangible assets.

## Shared Ownership, Shared Risk

Shared ownership goals and risks describe what is unique about financial families and the singular challenges they face. As more wealth- and business-owning families transition their wealth to the next generation, a frank discussion about what is “at risk” for each collective family can serve as a powerful and necessary tool to help family members achieve their shared goal of wealth and asset preservation.

For example, a family that desires to keep control of its closely held family business would benefit from an open and instructive review of its shared ownership and risk. Business-owning families see themselves as part of their business, making proper ownership and control their most critical decision-making factors. Therefore, when the original business founder or wealth creator passes ownership to future generations, family and financial relationships often become intertwined by complex legal structures, aimed at maintaining ownership and control, while irrevocably linking family members together.

As business-owning families subsequently sell their businesses and evolve into financial families, the issue of shared risk becomes even more complex. Typically, the family will increase in size and diversity, resulting in new and differing priorities that impact the family collectively, which the aggregate family must address.

These factors highlight the need for business-owning, and business-transitioning, families to reframe their family discussions around personal fears and family risks that go together with shared ownership.

Based on FOX's interviews with hundreds of successful family groups, the following four key questions emerge as central to family discussions about risk:

1. Why does the family want to stay together? Document the benefits of family togetherness.
2. What does the family want to accomplish with its legacy or wealth? Understand the goals articulated by the family members.
3. What do family members fear the most? Identify the risks that keep family members awake at night.
4. What can be done to mitigate the risks attached to these fears? Define the actions that change the risk profile for the family as a whole.

Hand in hand with the articulation and refinement of family goals, in the context of a family discussion about risk, is the process of protecting the family from the very risks that threaten its long-term goals. Though each family of wealth will have unique risks that interact with each other in unique ways, FOX identified the following as the most pervasive threats to financial families:

- Lack of a shared vision for the future
- Lack of effective decision-making processes
- Lack of transparent family communications
- Improper ownership structures
- Lack of appropriate diversification of assets
- Lack of focus on key family risks

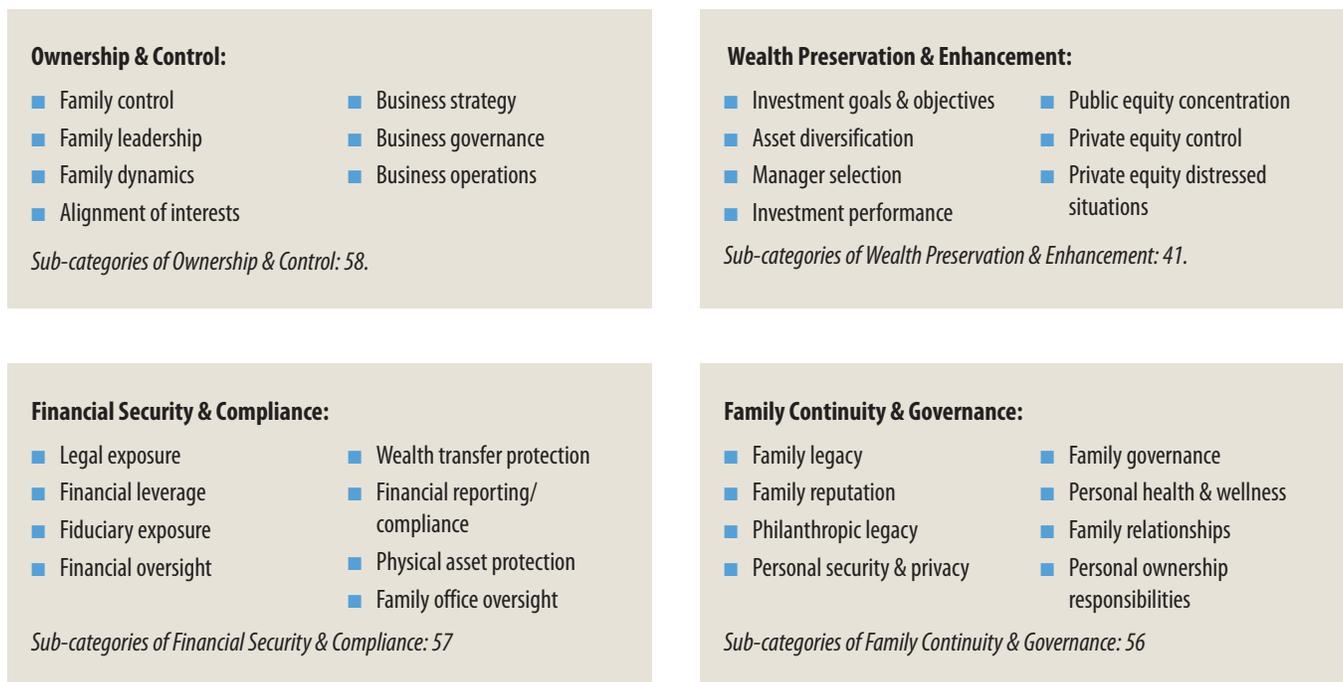
Often times in wealthy families, ineffective decision making stems from a lack of a shared vision for the future. Likewise, improper ownership structures within a family of wealth result from faulty estate planning, a lack of sufficient planning and excessively complex or unmanageable business structures. Furthermore, inappropriate diversification can result in a loss of financial and non-financial assets. All this, plus an unwillingness to acknowledge and address key family risks, will keep a family of wealth from becoming a financial family whose human, intellectual, social and financial assets span for generations in perpetuity.

### FOX's 30 Dimensions of Risk

To assess and manage the myriad factors that threaten families of wealth from becoming financial families, FOX identified 30 dimensions of shared risk. Each of the 30 dimensions of risk is connected to a financial family's desire to maintain control and perpetuate the family's values into the future. (See Figure 1 below.)

**Figure 1: What Are The Risks?**

## Family Risk Landscape



Source: Recasting the central role of the Family Office as risk manager, Family Office Exchange, 2006.

Figure 1 illustrates the four quadrants of risk, with their underlying dimensions as identified by FOX's panel of experts. As noted in each quadrant, these fundamental risks are divided into sub-categories of risk elements that are mapped to a specific risk dimension. Families of wealth should consider all of these elements and dimensions of risk.

The first fundamental goal or risk quadrant—Ownership & Control—focuses on issues that exist while the family is still involved in the founding family members' business. These issues vary from alignment of business interests to development of a business strategy around governance, operations and finance. Also included are other issues embodied within the larger financial family—issues around family decision making, leadership succession and interpersonal dynamics.

The second quadrant—Wealth Preservation & Enhancement—deals with more traditional notions of risk management, such as investment objectives, asset diversification, manager selection and investment performance.

The third quadrant—Financial Security & Compliance—involves technical and tactical areas of estate planning, financial reporting and regulatory compliance. Each area of financial security and compliance presents various consequences for the financial family to contemplate—from legal and fiduciary exposure to wealth transfer and physical asset protection.

Finally, the fourth quadrant—Family Continuity & Governance—outlines the most challenging issues for the financial family to confront as these issues relate to sensitive matters of family relationships and reputation. These issues should be at the core of every family discussion about risk in carefully arranged meetings where trained facilitators may be enlisted to provide assistance.

The appendix to this special report contains a checklist that maps the various risk elements to each of the 30 risk dimensions, and is incorporated into Abbot Downing's legacy consulting and family risk management process as a tool to assist the financial family assess its unique risk landscape.

As the sub-categories of risk elements are reviewed, a common thread emerges: the interrelatedness between these risk quadrants. For example, diversification—a key dimension in the Financial Security & Compliance risk quadrant—takes place not just within the family's portfolio but also within the family. Family members have different ways of expressing themselves—whether it involves contributing to the family's overall well-being, taking action

in an unfortunate circumstance or making decisions to the detriment of the family. This diversification—inherent in all families—relates to risk dimensions in both the Ownership & Control risk quadrant and the Family Continuity & Governance risk quadrant: leadership succession, conflict resolution, misunderstandings between family generations or branches, to name just a few.

Certain dimensions and their related risk elements in the Wealth Preservation & Enhancement and Financial Security & Compliance risk quadrants—specifically those related to the risks of overspending, over-leveraging, over-taxation and inattention to liabilities—require the financial family to be financially educated across all generations. As the family grows, so does the number of people who want to share in the family wealth. The family may spend or incur debt without a conscious thought on its effect on the family's long-term future. It is imperative that the financial family make prudent financial choices with regard to consumption, debt, and taxes, and balance it with stewardship.

However, prudent financial choices are directly tied to the financial family's values, interpersonal relationships, areas of affinity and shared vision for the future, among other things. A close review of the risk elements in the fourth FOX risk quadrant—Family Continuity & Governance—underscores the importance that family dynamics, communication and governance play in the continued viability of the financial family through multiple generations. In fact, family conflicts that drain resources and lead to costly mistakes may be a bigger risk to family wealth than poor investment or financial choices.

## What Is the FOX Process for Risk Management?

FOX's risk assessment process is proactive and structured to identify the unique risks that are associated with the financial family's goals and objectives. The six steps in this process involve prioritizing the risks, based on likelihood of occurrence and potential impact, and developing strategies to mitigate the impact of top-priority risks. The benefits of a risk management process that is comprehensive and formalized include:

- Focusing on risk as a means to engage family members in thinking about their future and focusing and clarifying their own goals.
- Prioritizing family risks to serve as a proactive catalyst for action without the need for a real-life triggering event.

- Educating family members on how to use a risk management model during times of crisis to manage critical issues, or during family transitions under extraordinary circumstances.

**Figure 2: Family Risk Management: A Six-Step Process**



Source: *Recasting the central role of the Family Office as risk manager*, Family Office Exchange, 2006.

As Figure 2 illustrates, the first step in the risk management process is to define long-term family goals, which is key to all areas of family wealth management. The fundamental question to be considered is, “What do you want to accomplish with your wealth?” The answers to this question will vary, but will become a part of the family’s collective voice. Goals that are common throughout need to be examined further to gain an understanding of how the family intends to attain each goal. For example:

- How will the family wealth be enhanced? By growing financial assets? Growing the family business? Investing in new businesses?
- How will the family continuity be maintained? By expanding the family business? Through social events? Charitable giving?

The second step in the risk management process is to identify the broad range of risks that might confront the financial family. This may be the most difficult stage in the process, as certain risks are foreseeable and may have been addressed by the family already, while other risks are more unique to a specific family and must be addressed and resolved based on individual circumstances. A review of the sub-categories of risk noted earlier also highlights how a family’s risk profile can extend beyond its financial concerns. Certain risks may be difficult to broach and impossible to quantify by monetary measures, but may still present the most significant threat to the financial family’s continued viability.

After the family’s risks have been identified, the third step in the process establishes a hierarchy based upon each risk’s probability of occurrence and its potential impact on the family. Those risks with a high likelihood of occurrence and high potential impact are classified as top-priority risks and are the first to be addressed in the risk management process.

Step four in the process is to analyze each top-priority risk and formulate strategies that the financial family can take to mitigate the risk. The mitigation strategies are then documented into an action plan.

Step five is a logical extension of step four and is the family’s commitment of its resources to implementing the action plan. These resources may be financial capital but can also be human capital, both from within and outside the family.

The last step in the risk management process closes the risk continuum. As top-priority risks are addressed and resolved, it is imperative that the risk landscape be continually monitored to identify any new risks, due to the ongoing, evolving dynamics of the financial family or its business and the ever-changing financial, legal, political or social environments of the family.

## Conclusion

Through a year-long study, FOX's interdisciplinary panel of experts identified 30 dimensions of risk that threaten to erode the human, intellectual, social and financial capital of wealthy families. While risk is necessary in terms of investment return or reward, families of wealth must have an effective process for acknowledging and managing their risks—which go well beyond financial risk—to survive as an enduring financial family. With the assistance of its team of professional advisors, the financial family can utilize FOX's six-step risk management process to (1) understand and prioritize its risks, and (2) create strategies and commit resources to manage these risks. An ongoing, proactive risk management process is crucial to the financial family's attainment of its goals and objectives.

*Abbot Downing acknowledges the extensive work and resources of the Family Office Exchange's (FOX) 2005 Thought Leaders Program. This interdisciplinary panel of experts was convened in early 2005 to tackle the issue of understanding, measuring and managing uncertainty for wealthy families. Working with an initial family risk assessment and management process developed by FOX, the panel enhanced the family risk model by isolating the risks unique to financial families, developing a methodology to prioritize the risks, and designing a process to manage risks more effectively. The panel's work was formalized as the Thought Leaders Management Compendium. As a crucial component of its Legacy Consulting, and with approval from FOX, Abbot Downing has incorporated the risk management compendium as the basis for its family risk management process. The foregoing discussion relies heavily on FOX's 2006 Thought Leaders Compendium and its article entitled, "Recasting the Central Role of the Family Office as Risk Manager" and is used by permission.*

## Endnotes

<sup>1</sup> A financial family is defined as a family that takes a multi-generational view of its enterprise (100 years+) and views the enhancement of family capital as an important goal for the enterprise (broadly defined as human, intellectual, financial and social in nature).

# Family Risk Elements

Reproduced with permission from Family Office Exchange's 2006 Thought Leaders Compendium: *Recasting the Central Role of the Family Office as Risk Manager*.

The 30 Dimensions of Risk: Checklist for Consideration

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## Ownership & Control

### Family Challenges

#### 1. Family Control

- Loss of ownership control.
- Lack of business transparency/clarity offered to all family members.
- Inappropriate legal structures for protecting business ownership.
- Termination of protective legal structures.
- Disenfranchised family shareholders.
- Lack of liquidity to pay estate taxes.
- Lack of proper exit alternatives.

#### 2. Family Leadership

- Lack of proper succession planning.
- Illness or injury of family leaders.
- Lack of interest from potential leaders in the younger generations.
- Lack of acceptance of ownership responsibilities.
- Lack of involvement options for younger generations.
- No system for evaluating family member involvement.
- Lack of entrepreneurial spirit.
- Lack of proper business ethics.
- Lack of support from board of governors.
- Reluctance to pass the baton of leadership.
- Poorly defined family employment practices.

#### 3. Family Dynamics

- Distrust between family owners.
- Lack of conflict management system.
- Imbalance of responsibilities.
- Unbridled ego or arrogance.
- Lack of respect for different talents and potential contributions to the family and family business.

- Misunderstandings between family generations or branches.
- Exclusion of certain family members, branches or generations.
- Introduction and impact of personal conflicts into business governance.
- Actions of a family member drawing negative media attention to the business.

#### 4. Alignment of Interests

- Inappropriate boundaries between owners and managers.
- Lack of leadership succession plans.
- Lack of proper corporate governance.
- Lack of proper alignment with owner goals.
- Lack of aligned compensation structures.
- Disempowered management.
- Disenfranchised shareholders.
- Lack of exit strategies for shareholders.

### Business Challenges

#### 1. Business Ownership Strategy

- Lack of long-term view of business goals.
- Lack of drive for renewal of business model.
- Lack of focus on core competencies.
- Inability to separate emotions from business decisions/strategies.
- Lack of economically driven decision-making.
- No consideration of competition or other environmental risks.
- Joint venture business exposure.
- Lack of external collaboration.

#### 2. Business Governance

- Improper selection of board members.
- Lack of independent shareholder voice.
- Lack of alignment of interests between owners and managers.

- ❑ Lack of disclosure of operating performance.
- ❑ Improper checks and balances for review committees.
- ❑ Problematic overlap between family governance and business governance.
- ❑ Lack of external expertise/viewpoints.
- ❑ Inability of employees to openly express concerns to owners.
- ❑ Restricted shareholder options.

### 3. Business Operations

- ❑ Lack of cost consciousness.
- ❑ Improper internal collaborations.
- ❑ Inability to attract/retain talented managers.
- ❑ Lack of internal controls.
- ❑ Inability or unwillingness to adapt to changes in the marketplace.
- ❑ Lack of boundaries between personal and company finances.

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## *Wealth Preservation & Enhancement*

### 1. Investment Goals And Objectives

- ❑ Lack of clear investment objectives for owners.
- ❑ Inappropriate time horizons.
- ❑ Unacceptable levels of volatility.
- ❑ Improper use of ratios and analysis in investment decisions.
- ❑ Lack of planning for liquidity needs.
- ❑ Failure to account for the impact of taxes.
- ❑ Inadequate investor education.

### 2. Asset Diversification

- ❑ Inadequate investment policy statements.
- ❑ Improperly constructed strategic asset allocation (historical vs. forward-looking assumptions).
- ❑ Unsupportable tactical deviations from target allocations.
- ❑ Non-correlation of asset classes.
- ❑ Lack of agreement among owners on proper diversification and risk parameters.
- ❑ Concentration of investments in one country or one currency.

### 3. Manager Selection

- ❑ Lack of a defined manager selection process.
- ❑ Redundant manager positions.
- ❑ Insufficient manager due diligence and/or site visits.
- ❑ Lackluster managers.
- ❑ Poor advice from managers overly motivated by commissions.

### 4. Investment Performance

- ❑ Inadequate performance against benchmarks.
- ❑ Inadequate controls and monitoring procedures.
- ❑ Inability to discern between short-term losses and long-term decline.
- ❑ Neglecting to modify portfolio as investment risk exposure and performance changes.
- ❑ Unforeseen event triggering loss in equity value.
- ❑ Fraudulent recordkeeping and reporting.

## Public Equity

### 1. Public Equity Concentration

- ❑ Single stock concentration of wealth.
- ❑ Livelihood tied to stock dividends.
- ❑ Lack of reliable research on concentration risks.
- ❑ Emotional attachment to legacy company.
- ❑ Personal identity linked to company name.

## Private Equity

### 1. Ownership Exposure

- ❑ Loss of ownership control/influence.
- ❑ Termination of protective legal structures.
- ❑ Inappropriate or improper ownership or title.
- ❑ Business partner/joint venture exposure.
- ❑ Illiquidity of committed capital.
- ❑ Lack of regulation for private ventures.

### 2. Distressed Situations

- ❑ Lack of proper due diligence process.
- ❑ Lack of proper risk assessment.
- ❑ Inability to spot troubled companies.
- ❑ Resource constraints during workout situations.
- ❑ Inability to judge deal quality.
- ❑ Inability to fund proper managers for turn-around situations.

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## *Financial Security & Compliance*

### 1. Legal Exposure

- Lack of awareness of changes in the law.
- Inappropriate processes for compliance with multiple jurisdictions.
- Exposure to multiple international tax systems.
- Lawsuits with adverse judgments/litigation.

### 2. Fiduciary Exposure

- Appointment of inappropriate trustees.
- Improper delegation of trustee duties.
- Self-dealing or conflict of interest as trustee.
- Disrespect for fiduciary control.
- Lack of succession plan for individual trustees.
- Lack of education on role and responsibilities of trustees/beneficiaries.
- Mismanagement of trust assets.
- Improper termination of trusts.

### 3. Wealth Transfer Protection

- Incomplete or outdated estate planning.
- Lack of cohesive branch planning.
- Improper jurisdiction planning for wealth transfer.
- Loss of flexibility due to over-planning.
- Tax penalties due to improper legal structures.
- Lack of liquidity to pay estate taxes.
- Improper estate administration.

### 4. Physical Asset Protection

- Failure to monitor personal property.
- Disregard for intellectual property.
- Inconsistent management of estate properties.
- Mismanagement of private travel assets.
- Inadequate protection of art and collectibles.
- Inadequate insurance coverage levels or lapses.
- Financial soundness of insurance carrier.
- Insurance fund performance results.

### 5. Financial Leverage

- Balance sheet debt/equity imbalance.
- Improper leveraging of assets.
- Improper arbitrage of opportunities.
- Improper use of structured derivatives.

### 6. Financial Oversight

- Poor monitoring of advisors.
- Lack of integration among advisors.
- Failure to retain competent advisors.
- Lack of alignment of interests with financial advisors.
- Lack of follow-through/fulfillment of financial plans.
- Improper accounting and recordkeeping.
- Mandatory disclosure of personal financial information.
- Inappropriate financial strategies.
- Liability from professional performance.

### 7. Financial Reporting/Regulatory Compliance

- Aggregation of family financial information.
- Inaccurate consolidation of data.
- Inappropriate access to financial data.
- Absence of data integrity across systems.
- Improper technology systems design/oversight.
- Absence of proper data accuracy/storage.
- Reliance on obsolete technology.
- Lack of regulatory filing/legal compliance.

### 8. Family Office Oversight

- Unclear mandate from the family for the office.
- Insufficient capital allocated by the family.
- Lack of proper governance and committees.
- Lack of clearly defined roles and responsibilities for managers.
- Insufficient or ill-defined policies and procedures.
- Employees' non-compliance with company policies.
- Lack of financial checks and balances or procedures.
- Misappropriation of funds.
- Lack of analysis of "make or buy" alternatives.

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## *Family Continuity & Governance*

### 1. Family Legacy

- Lack of development of areas of affinity.
- Lack of representative family governance.
- Disagreement on role of family stewardship.
- Disagreement on definition of family.
- Lack of agreement/support for family leaders.
- Lack of training for future leaders.
- Loss or transition of family leadership.

## 2. Philanthropic Legacy

- ❑ Lack of clarity or consensus about philanthropic goals.
- ❑ Imbalance between collective and individual philanthropy.
- ❑ Lack of consideration for donor intentions.
- ❑ Lack of discipline in sticking to strategic mission.
- ❑ Lack of execution of fiduciary duties for foundations.
- ❑ Lack of selection of experienced board members.
- ❑ Improper foundation compliance.
- ❑ Imprudent investment diversification.

## 3. Family Governance

- ❑ Lack of shared vision in the future together.
- ❑ Lack of transparency in family dealings.
- ❑ Imbalance between individual freedom and family loyalty.
- ❑ Lack of a clear decision-making process.
- ❑ Lack of appropriate governance structure.
- ❑ Improper vesting of power in governing bodies.
- ❑ Lack of clear communications among family members.
- ❑ Lack of inclusiveness of younger generations and in-laws.
- ❑ Lack of equitable exit strategies.
- ❑ Conflicts of interest in roles played by representatives.

## 6. Family Reputation

- ❑ Lack of sensitivity about private family matters.
- ❑ Loss or harm to public image.
- ❑ Lack of agreement on role and visibility in community.
- ❑ High profile media exposure.
- ❑ Lack of media training for family members.
- ❑ Improper or negative use of media by family member(s) to gain power.

## 7. Family Relationships

- ❑ Lack of trust among family members.
- ❑ Divorce/custody battles.
- ❑ Disrespect for personal differences/learning styles.
- ❑ Unmotivated family members.
- ❑ Interpersonal family relationships/conflicts.
- ❑ Inadequate communication.
- ❑ Lack of models for raising responsible children.

- ❑ Lack of clear boundaries about power and influence.
- ❑ Overbearing personalities.
- ❑ Miscommunications due to language and cultural differences.

## 8. Personal Security & Privacy

- ❑ Breach of confidentiality by employees/family.
- ❑ Lack of crisis management planning.
- ❑ Lack of protection for personal privacy and safety.
- ❑ Lack of awareness of or disregard for international travel risks.

## 9. Personal Health & Wellness

- ❑ Lack of preventative healthcare options.
- ❑ Improper medical diagnosis or treatment.
- ❑ Mismanagement of chronic illness.
- ❑ Genetic disorders/diseases.
- ❑ Substance/alcohol abuse.
- ❑ Issues of the aging process/eldercare.

## 10. Personal Ownership Responsibilities

- ❑ Lack of awareness or understanding of family goals and decision-making process.
- ❑ Unwillingness to focus on important ownership issues.
- ❑ Lack of skills needed to select qualified financial advisors.
- ❑ Lack of clarity about owner responsibilities.
- ❑ Lack of training on basic financial concepts.

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