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Link to Partners Profile

Chinese Families, Globalization, Governance and Wealth Transition

Are ultra-HNW Chinese families from the Mainland, adopting the appropriate strategies to expand their businesses and their wealth and then transition both to their younger generations? A roundtable discussion co-hosted by Cone Marshall and AllianceBernstein navigated these waters, guided by an expert who has studied more than 100 successful ultra-HNW family dynasties.

Executive summary

There are numerous vital issues facing successful, ultra-HNW Chinese families in managing the transition of their wealth across generations. Cone Marshall together with AllianceBernstein organised a private discussion to explore how these Chinese families handle their internal dynamics and governance, how they and their businesses are dealing with family wealth transition and corporate succession. And the discussion was set within the broader context of the rapid evolution from a traditional Chinese culture to one that blends global perspectives and outlooks.

The discussion titled "Chinese Families in an era of Globalization and Wealth Creation " lessons learned in family governance and transition" was led by Dennis Jaffe and co-hosted by Cone Marshall's Managing Director and Global Head of Fiduciary Services, Peter Golovsky and AllianceBernstein's Principal and Head of Family Offices Asia, John E. Oden.

Key issues facing successful Chinese families in managing transitions across generations and important learnings from globalization were provided by the event's special guest, Dennis Jaffe, PhD, who also shared his unique insights on his recently launched paper, "From Village to Global in Little More Than A Generation - The First Two Generations of Mainland China Family Enterprises", which represents a personal documentation on his travels through China, studying the organisation and governance of 43 ultra-HNW Chinese families.

The perspectives Jaffe provided, also highlighted the differences and the similarities between these successful Chinese families and their counterparts in the US, Europe and elsewhere, following a multi-year project Jaffe pursued to meet and interview more than 100 of such families globally.

Peter Golovsky introduced the discussion, highlighting the dramatic growth of private wealth in China, stating that family businesses account for 70% of the nation's vast GDP. He reported that in 2017 alone, there was a 32% increase in the wealth of the ultra-HNW families to an estimated USD2.7 trillion and that the figure is set to outstrip the US within three years. Golovsky added, that China is on the cusp of a significant transition of wealth between first and second generations, with an increasing focus on the need to advise these families on governance, succession and wealth transfer, particularly as they expand globally.

The discussion then explored the vital characteristics that families should exhibit and maintain across generations in order for their businesses and their wealth to survive and prosper. And the discussion also highlighted some of the obvious pitfalls that all too often impede the wealth of such ultra-HNW families surviving more than two or three generations.

DR JAFFE LED THE ROUNDTABLE discussion, supported by Cone Marshall's Managing Director and Global Head of Fiduciary Services, Peter Golovsky and AllianceBernstein's Principal and Head of Family Offices Asia, John E. Oden. The roundtable guests included 20 top-level legal, tax, trust and accounting advisors, all of whom have extensive experience in working with ultra-HNW families in China and further afield across the region.

"In my new paper on Chinese family enterprises that we launch today," Jaffe remarked, on opening the main discussion, "we report that family businesses in China are now the most significant sector and contribute 70% of national GDP, employing around 75% of the nation's workforce. It is therefore of vital importance to them and to the nation at large how they deal with intergenerational wealth transfer and business succession. And it is just as essential to understanding how they are going global and building global enterprises that to some extent match the globalisation of their family wealth and lifestyles."

He then gave a presentation to highlight some of the insights he gained from some of his travels and his interviews with global families that are in business together and that have stayed the course to remain united as extended families with a common set of purposes and a similarity of business and family values. The project has taken five years and he recently completed his interviews with the 100th family.

"There are many consultants working with such families who might be advising them to have a family constitution, a family council, a value statement, he reported. But my approach has been to first research this field thoroughly, hence my global project to travel the world and interview families and dynasties that were enduring over 100 years; the mission was to see how they had passed wealth onto the third generation successfully and what lessons could be learnt. I also wanted to hear their stories, as we can learn more from that than we do from statistics."

'Generative' families

Jaffe explained that these families are called 'generative families', meaning they create and renew value. "These are families that from a wealthy founder, have continued to create value, not just financially but also as families through the next generation in

Hubbis - Cone Marshall - AllianceBernstein Roundtable in Hong Kong terms of service to the community. Our research was global, of course, but within this, we also focused on the 43 families in Mainland China that are entering the second and third generation and what we learned from those conversations."

He explained that the universe of families he covered spanned 20 countries, that all of them have a net worth of at least USD500 million and that they are all families with a related identity, in other words, they remain very close, highly focused and extremely well organised. "Many of them will be recognised names, but we decided to keep this entirely anonymous," he added.

The common qualities and values

He then highlighted the commonalities across these families. First, they represent shared values across the family and the businesses that are deeply embedded in their activities and approaches; they balance legacy values and redefine them each generation because the younger members will always have new emerging values.

Secondly, these families are resilient. They might have started in one business sector, but they evolve, for example selling legacy businesses, listing entities, diversifying and innovating continuously.

Thirdly, the families have a very high level of engagement with the next generation, which means they invest for their wealth and their businesses in those next generations. For example, Jaffe explained that one family has a what they call social dividend, which is a large trust established for every blood member of the family to have a guaranteed education, healthcare, a modest (or better, if deserved) house, and that there are opportunities to access family funds to obtain loans and to make investments.

"They are," he noted, "also very transparent within the family entity, although they might be perceived as highly private to the outside world."

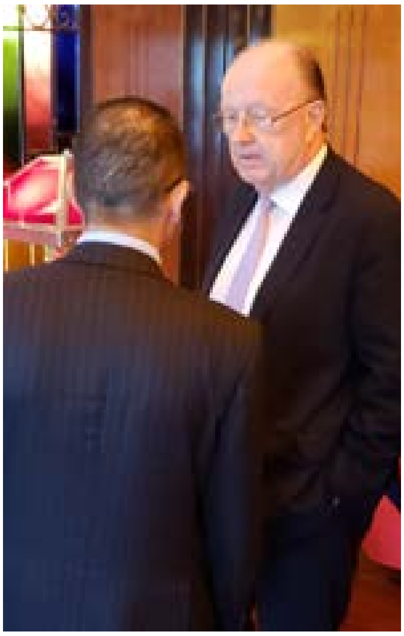
Order, organisation, obligation

These types of families also have orderly, carefully evaluated family governance and a mutual sense of obligation shared across generations. They will have a family organisation of some structure, perhaps a family council, a family assembly, family meetings, family educational plans, family activities, next-generation activities and business activities, boards, advisers, committees and so forth.

Jaffe gave the example of one global family, originally of Indian blood, now owning 200 businesses around the world. "They are totally below the radar," he reported, "but they have a rule saying no more than three family members can live in any country. If you are the fourth family member look for another country and go and open a new business, that is how they expand continuously."

"They also all have next-generation education programmes, summer camps for their children and grandchildren, regular briefings and so forth," he noted. "They believe that learning as a family is different from what they can learn in the schools."

Jaffe moved his focus more directly on his findings from his research on China. "My study is only about Mainland China families since the 1978 reforms and opening policy, when numerous family businesses first emerged. Since that time the economy has expanded apace with many families sending their children overseas for education and returning home with new ideas. This has meant that their values have been evolving and what we see developing is a blend of eastern and western cultures. Over time we then see the younger generations forming global bonds, spending far more time in the west, blending cultures."



Asian family values and history

He then explained how the view of these families must take into account that these are Chinese families in Asia and not western families in the west. "In western thinking," he observed, "the individual is equal, equally heard and so forth. But these Chinese families consider their members part of a society and they cannot think of themselves as separate. They have a sense of obligation. They espouse the more widely-held Asian view of the sense of being related, linked to thousands of years of history, with an obligation to your family, part of a large connected system."

A guest interjected and remarked that what he often finds in working

with such families, especially in Hong Kong or Taiwan, is that they embrace the culture of an older generation as the basis for the planning for their family and businesses. "This," he commented, "is not necessarily the culture of the younger generations, and that can create issues going forward. Accordingly, I think the good adviser is the adviser who challenges some of these views because I think families have a lot to learn from each other in different parts of the world."

A Chinese attendee observed that families are gradually adapting to globalisation to make their businesses more competitive. "Sometimes, "he remarked, "this will create conflict inside the companies, as the older generation of employees or leaders are not happy with the direction coming from younger generations if they are handed the reins of the business."

Too much, too soon?

Jaffe concurred. "Take one South East Asian family we have talked to," he noted. "The father runs the business in a hierarchical way, while the son likes to run it collaboratively. I am not saying which approach is the right way, but the son's style might at this stage be somewhat too loose to make the business succeed in the future compared with the long-standing approach of his father."

"That is indeed a major issue we see," said another expert. "The younger generation might have the ideas but perhaps not the power to implement, or the timing might not be right, so it is often difficult to get the right dialogue and right relationship going on between the generations. These younger would-be leaders then get frustrated and possibly leave."

Taking ownership

"Yes," concurred another expert, "and then he or she might move to another company where they might emerge as a fine leader and the family would have lost all the social and business capital because the father or the founder generations are unable to accept these innovations."

Another guest suggested that some people with different interests within the family might, for example, be able to take ownership of something that they really believe in, so that within a cohesive whole and retaining the power of the family and the business individual members can pursue their own particular interests.

A fellow attendee added that hand in hand with leadership matters are the vital governance arrangements within families. "There is no shortage of legal cases in the courts in Hong Kong where there are family disputes because there is no proper delegation of authority; some of these cases go on for years and are very corrosive."

Playing politics

Another attendee added that many of the wealthiest Chinese families like to extend their power into the world of politics, locally, regionally or even nationally. "We can see that in the political scene there is very big change after current President has taken control. Following the winds of change in politics is therefore key in Chinese families, as the closer they get to the centre the better positioned they are to win in the future."

The changing policy towards the birth rate is also having a dramatic impact. Whereas the one-child policy created a lot of older people and fewer young, the policy has now been relaxed to two children and soon there is likely to be a complete loosening of control.

"It might no longer be the case in the future that the first-born child, especially if male, takes the reins of power in the family," said one guest, "The current thinking is moving towards giving the power

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to the person who can be the leader, whether male or female, and whether or not firstborn."

A guest noted that some of the very successful Chinese families have been able to have two or more children, as they were wealthy enough or connected enough or both. "I think one of the reasons these families and businesses are successful is because they are more inclusive and more open, in fact, most successful families we know of were able to have two or more children and that helped them diversify, build different businesses, adapt and change."

The dividing line

Another trend highlighted is the ongoing separation of business wealth and private wealth. "Getting wealth out of China is now more of an issue, with tighter foreign exchange controls," said one attendee.

A guest observed that from his perspective of being an only child from a Chinese family it is more difficult for the wealth of smaller families to survive in China because the type of society is one that relies on 'connections' and with one child it is very easy to suddenly have no family connections. "That is why all those wealthy families try to have more children," he said. "Sometimes those children are born overseas, which also helps later on in bringing money outside China as the family invests in global markets."

Nominee arrangements still exist widely, a guest noted. "These are of consideration when looking both at compliance and also wealth transition," she explained. "Additionally, I would say that families are becoming more adaptable to compensating appropriately those offspring and family members who contribute to the business and those who, for whatever reasons, prefer to focus on other interests and opportunities. That is a good thing about wealth, as it allows time for people to focus on their interests, whether business-related or other initiatives."

Expanding on the nominee conversation, one expert added that the nominee arrangements are often not documented. And a fellow attendee, a lawyer, observed that there is often what he called a lamentable lack of planning that tends to go on around offshore structures.

Dragging their feet…

"It is quite shocking how little planning there is," he observed, "and we see this on a daily basis, while the older generations are only getting older. Secondly, I would add that it is often the case that private equity exponents benefit rather handsomely from the next generation not wanting to go into those businesses, meaning these are happy hunting grounds."

A wealth management professional added that more families are also looking at the next generation as business leaders, but increasingly comparing them to the third-party professional

managers they might be able to attract instead, or alongside.

"I agree," commented another attendee. "And we also see less automatic selection of the successor taking place and more of the 'selling' of the idea of entering the family business to the next generation to gather up the most talented people. That is a good motivator to have family discussions, to be more transparent, to have a more open dialogue about what the business will become, how it must evolve and so forth."

Opening a world of ideas

An attendee commented that the role of the adviser to these families should not simply be to do what the family wants but to make them aware of other options. "I think that increasingly there is this gap between what the family says they want and what you as an adviser know they need," he said. "We need to make them fully aware that there are other possibilities, for example instead of passing the business on to the son or other family members, the company can be sold, or other partners can come in, bringing equity or collaboration. There might be natural leaders already in the business that can take it forward."

One adviser noted that the first step in the wealth planning process is often for the family founder or leaders asking what people do to plan their wealth and succession properly in other countries, for example in the US, and what other clients in Asia do in certain situations. He said this generally helps as the starting point for a sensible, productive dialogue on these generally sensitive matters.

"We also have to be wary of the copycat effect where clients simply want to copy what they hear other people have done in certain situations," added a lawyer at the discussion. "I think sometimes it is a challenge for us as advisers to say, well actually there are other options that the client might want to think about which potentially could provide better outcomes."

The fear factor?

Another wealth adviser said that in his experience there are two main reasons that clients do not plan appropriately. "One," he said, "is that many people do not like transparency, in fact, Asian families generally do not like transparency and so the more documented things are the less comfortable they feel. Secondly, they fear certain people, often the spouse or certain relatives, and so the more things are documented, the more those relatives might be able to see."

As to political matters, he said this can be a positive stimulus for discussions. "We prefer to frame the discussion as the sovereign risk, not politics or geopolitics," he remarked. "For example, we might suggest they diversify their business and wealth outside their home country because of sovereign risk. I can tell you for sure that for all the Chinese HNWI families I work with that is one of the top three items of concern to them."

Going boldly towards globalisation

Jaffe responded by noting that all of the Mainland Chinese families in his study had indeed diversified well beyond their home base in China. "That is similar throughout all these families as one of their major goals," he explained, "to go for example from being successful in China to having a global presence."

The discussion turned to the high number of wealthy families that have opened a business in the US or expanded their assets there, noting that foreign grantor trust (FGT) planning rules have evolved. FGT is a term given by the US for a trust that have certain features and therefore have a particular tax status under the US tax code. An irrevocable trust can be treated as a grantor trust for tax purposes when the grantor meets the tax department's requirements to become the owner of the assets.

"The foreign grantor trust planning rules have changed as of the end of 2017, with some tax efficiencies with structures in the US," remarked one wealth adviser. "We have seen an increase in real estate investment because of that, although not as much as we might have expected."

A lawyer in attendance added that the changes are however not dramatic, although existing structures should be reviewed.

Keeping options open

"The fundamentals are still there and then it really comes down to whether the client intends to migrate to the US and whether they keep a structure that balances between the US and non-US," he explained. "I for one rarely shut down the foreign trusts, I keep them working with the US trusts, regardless of how much is there. Some firms, however, work very strictly, and advise that clients shut down the foreign structure and move to the US if that is where the beneficiaries."

He said that his approach is to prefer flexibility, especially as some clients might want to leave again at a later date. "Meanwhile, they must make sure they report properly, and they work with good accountants to make sure they comply with all regulatory requirements," he added.

She added that more of the second tier of Chinese wealthy families are also getting this broader perspective from their advisers. "They are gradually getting the message that they need to plan appropriately," she remarked, "particularly as soon as they want to interact with the US or the UK, perhaps first for education for their children, then it might be buying real estate and that gradually brings them into appreciating the need to plan in the wider context."

Another expert commented: "What we often have to do as advisers is really encourage people to understand that although they are really not used to being in this situation, and where there is substantial wealth involved, the planning becomes extremely important. However, we often see a sort of denial about it all."

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Another attendee concurred. "Yes, we still have a number of New Zealand trusts set up for Asian and Chinese families," she reported. "For whatever purposes, sometimes it is better not to put all your eggs in one basket, so we keep a trust for the financial assets, maybe there is a separate trust for the art collection, a separate trust for the fancy car collection and so forth. That is another reason why working with different advisers is advisable, in order to obtain their perspectives on the best solution for a particular family."

The generation games

A fellow attendee advised remembering that the wealth creators have often come from humble origins. "The situation of such huge wealth and the globalisation of wealth, businesses and family can be somewhat intimidating for them, so it is often easier to sort of deny it all and not face up to planning around it," he observed.

"Then," he continued, "you have the offspring that have been raised with wealth and they have completely different psychology and set of attitudes. Our role is then to help the founder or older generation understand a little bit about their journey, the benefits of success and also the challenges that they have to be taking into account."

"I agree," said a lawyer, "for example one area that we see considerable reluctance to address is for families with US real estate, as they seem to have minimal or zero interest in paying for any type of advisory or structural planning around it. However, the necessary structures are relatively easy if done in advance."

Seeing the big picture

Concluding the discussion, Jaffe made a few additional comments. "One thing that is often over-estimated is the difference between cultures," he observed. "Actually, from our research, a wealthy family is a wealthy family wherever they are and most have similar issues to deal with. Working with families on governance and succession is very important, especially as there is a view that wealth if handled poorly, can actually destroy families. Moreover, as people live longer and longer lives the dynamics of succession are changing."

Jaffe gave the final comment, advising of the need for families to step back from their wealth and look at the bigger picture. "We can discuss structuring and legal solutions, but from a governance perspective, first of all, a family needs to have an understanding of what they want to do with their wealth."

This, he advised, involves also getting together regularly as a family and sharing some of the possibilities and some of the options more broadly than just the older generation. "That is happening more and more, we see nowadays," he said.

"So, in brief, structures are important but they must be set within the context of the overall vision of the wealth and the future generations. There are numerous considerations that need to be discussed openly. We do not expect that to result in some sort of quick fix, it needs to be set in the context of families being generative, building for the future in an inclusive fashion." ■