MarshMcLennan Agency

Private Client Services

Family Office Risks: Managing the Impact of Change

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Contents

Introduction

Over the past decade, family offices have faced increasing complexity in the matters they handle on behalf of high-net-worth families. Just as each family is unique, with a vision and goals that vary, so too are the risk management needs of every family office. In addition to managing local and global assets, which have diverse and converging risk exposures, family offices are seeing the expansion and transfer of wealth to the rising generation.

According to a recent study, $15.4 trillion of high-net-worth capital will transfer to the next generation by 2030.[1] These changes and the growing convergence of risk globally will amplify the challenges for family offices and the family members they represent.

A risk trend that has emerged in the past several years, particularly for family offices, is the marked and deepening interconnectedness of:

Strategic risks

As seemingly incremental changes add up, they can have a significant impact on families. Among the strategic risks family offices face are the expansion of the family, rising wealth, generational shifts, cyber risks, and natural catastrophes.

Commercial risks

Severe weather, economic volatility, increasing regulation, and litigiousness are among the factors behind expansion in property and liability risks for commercial enterprises. Even nonprofit institutions are increasingly potential targets of litigation.

Personal risks

From homes, automobiles, and watercraft, to private art collections, personal assets are becoming more exposed to property damage, while at the same time affluent individuals face a greater risk of personal liability and both physical and cyber security threats.

Financial risks

Families' increasing involvement in direct investing, impact investing, and philanthropic endeavors introduces new and sometimes discrete exposures that can blur the lines between personal and commercial risks. Market volatility, fiscal policies, and differing approaches to trade and tariffs are creating a challenging geopolitical environment for businesses and investors worldwide.

In the context of a family enterprise, this convergence means that individual family members, as well as the corporate entities the family may own or participate in, are exposed to loss from multiple sources. This is reflected in families' growing sense of risk exposure and concern about global trends.

The 2018 Family Office Benchmarking Study by Marsh McLennan Agency Private Client Services (MMA PCS) found that 58% of families surveyed said they experienced a greater or much greater level of personal risk exposure in the last three to five years, and 56% anticipate their level of personal risk exposure will continue to increase in the next three to five years.

Strategic risks

The ability to identify new and emerging risks in larger trends, including generational differences and globalization, is important for family offices so they can prepare family members for exposures as they arise. Among the key concerns of families are complexities relating to family expansion and growing wealth, cyber and kidnap and ransom risks, and natural disasters.[2]

Growing wealth and expanding families

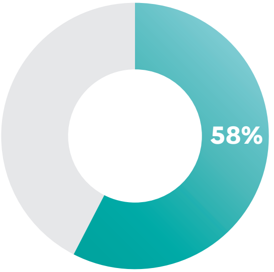
At first glance, growing wealth is a positive thing, but it adds complexity and exposure to loss, which require the family office to look closer at — perhaps even augment — the family office team's capabilities. As families extend and their aggregate wealth expands, they are likely to encounter the need to re-assess their tolerance for risk and adjust their risk management and insurance programs.

Transferring assets and acquiring new ones, such as homes in multiple countries, can create coverage gaps if families do not look holistically at their exposures. Younger generations may not have the same risk tolerance as those of prior generations in a given family, which can result in differing approaches to protecting their assets. For example, some family members may want to self-insure while others prefer traditional insurance products. Even when all or most family members do buy insurance, some may seek different deductible levels.

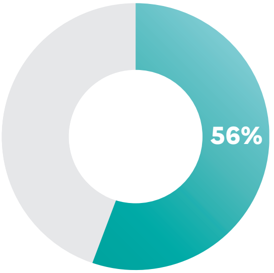
The creation of family insurance standards, such as requiring all family members to maintain excess liability coverage and consistent minimum liability limits and deductibles on homes and vehicles, enables family offices to align insurance protection with the family's risk tolerances and sets the stage for the deployment of more efficient and effective risk management strategies.

For example, a lack of family insurance standards might cause a younger family member to opt for lower liability limits on a car or home that won't align with the attachment point of existing excess or umbrella policies. This could create an unintended gap if a claim is large enough to trigger the excess coverage but the primary limits are insufficient. While easily remedied, it is a common and costly oversight.

A more coordinated, standardized approach to protecting assets also can result in more favorable terms, conditions, and pricing. Shifting from a patchwork quilt of individual policies to a strategic program can generate savings, support the family insurance standards, and greatly reduce the possibility of financial loss due to coverage gaps.



Families experiencing a greater or much greater personal risk exposure level in the last three to five years.



Families anticipating an increase in their personal risk exposure level in the next three to five years.

Generational shifts

While many factors may influence a new direction within family offices, one of the most complex is generational differences. More family offices are now serving at least three different generations in a single structure, and some are serving four generations at once. The rising generations, which include millennials, are poised to take control of family leadership as well as family assets, which may amount to more than $68 trillion over the next 25 years.[3] Younger generations often differ from older ones in their goals, communication styles, and risk tolerances. These are challenging and important considerations for family offices. Varying risk tolerances can make the family office's responsibility to protect family members and their assets more difficult. Generational differences can be a strategic risk for family offices, particularly when younger generations hold different opinions on the family's overarching direction and objectives.

For example, members of a rising generation may no longer wish to participate in a long-held family business, or feel strongly that the family should diversify its interests in new areas instead of concentrating on a core asset, as previous generations often did. At the same time, older generations that have built and maintained successful enterprises may want to see those continue. This divergence can lead to contentious discussions and disengagement, which put additional pressures on the family office team.

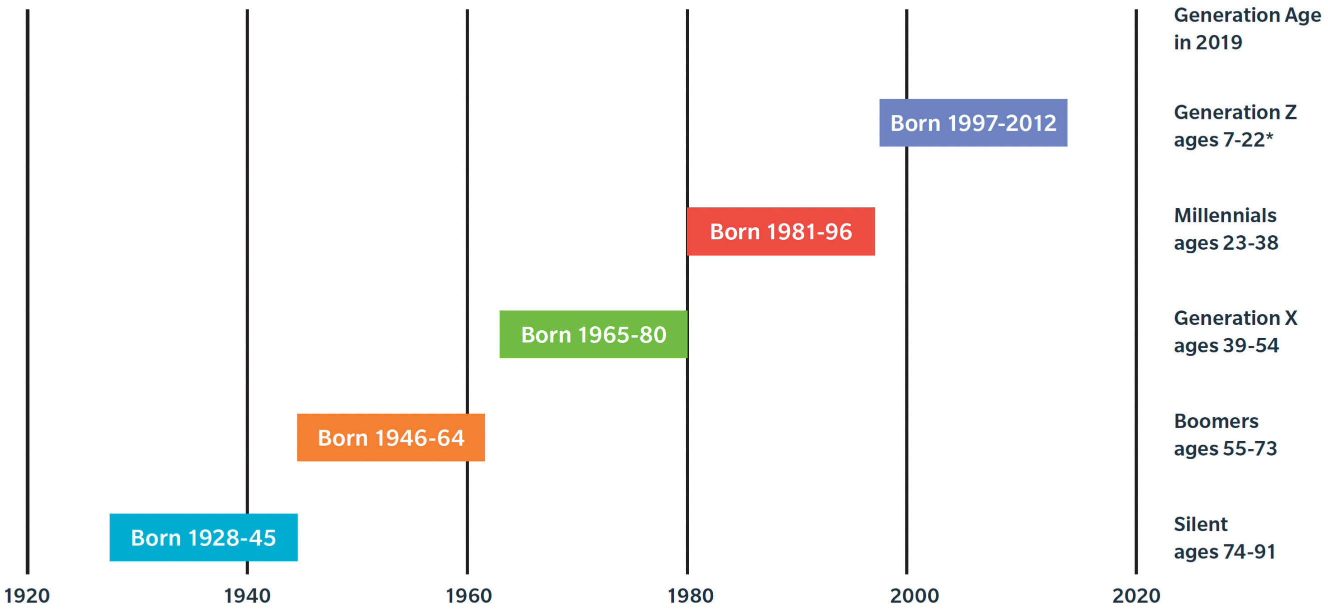
Education is a powerful tool for family offices to build consensus and family member engagement. Educational opportunities such as consortiums and leadership development programs also are important for families as they provide opportunities to coalesce around common goals and to prepare rising generations for succession.

Family offices particularly need to focus on educating family members about risk. In the Internet era, family members have access to information as never before, but what they often lack is insight — guidance on how to prioritize and interpret what the data is saying. That creates both a challenge and an opportunity. Rather than think about personal risk in purely transactional terms such as coverage and price, family offices can engage families in a more intentional role in defining risk through a more holistic, strategic lens.

In its 2019 report, "Capturing Opportunity and Managing Risk in the Next Decade," the Family Office Exchange (FOX) recommends that families adopt a team approach to managing risk.[4] Principals, family members, executives, and advisors all perceive risks differently. As a result, FOX suggests that families integrate an opportunity and risk committee, comprising family leaders and advisors, into the family's enterprise governance. Such a committee can be a go-to resource for risk assessment and mitigation as well as to coordinate responses when something unexpected happens. Family offices that utilize their risk advisors in the education process with family members are more confident about the strategies they implement and have greater success in managing expectations at the time of a loss.

01 | The Generations Defined

Source: Pew Research Center



*No actual chronological endpoint has been set for this group. For this analysis, Generation Z is defined as those ages 7 to 22 in 2019.

Catastrophe risks

Over the past 20 years, the frequency and severity of catastrophic events have increased as the world has come to recognize the impact of climate change. The highest total insured catastrophe losses on record, US$144 billion, occurred in 2017. By comparison, 2018 insured catastrophe losses totaled US$76 billion.[5] Combined, the losses represent the highest-ever figures for consecutive years. Recent history shows that high-impact natural hazard-driven catastrophic events are becoming more frequent. For example, four of the five most expensive insured hurricane losses in United States history have occurred since 2012, with three happening in the same year, 2017, according to the Insurance Information Institute.[6]

02 | Five Costliest Hurricanes in US History

Source: Insurance Information Institute

US $221 billion

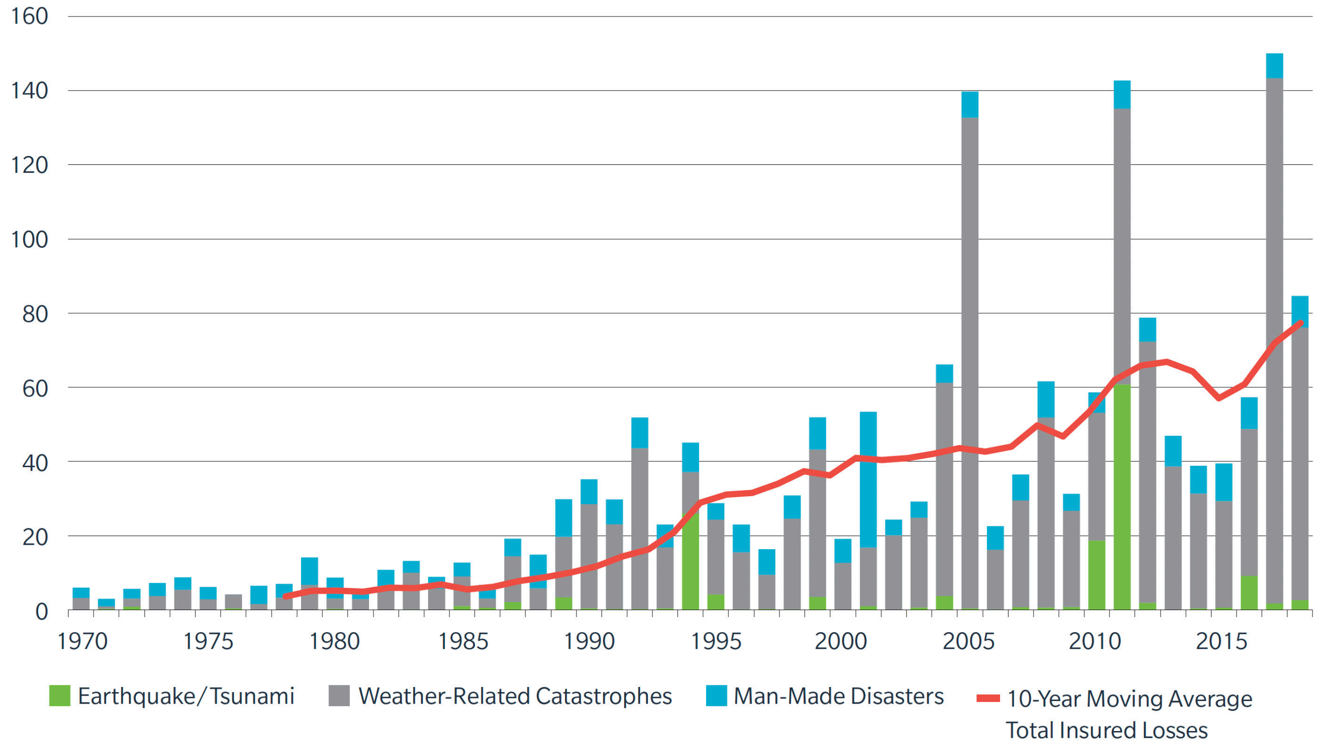
Insured catastrophe loss total from events in 2017 and 2018.

2017 losses of US $144 billion were the highest on record
2018 losses of US $76 billion were the fourth-highest

Source: Swiss Re

03 | Catastrophic Events 1970-2018

Source: Swiss Re Instituter



Severe windstorms, floods, and fires pose major threats for family offices, especially those managing significant coastal and wildfire exposures. Natural disasters and other catastrophic events do not discriminate between personal and commercial assets. Mitigating the potential catastrophe exposures of a family's business holdings as well as their personal property is a significant strategic concern. Exposure mitigation also can assist in securing adequate insurance coverage, as insurers increasingly insist that property owners in high-risk zones implement risk-reduction measures such as installing impact-resistant glass, brush clearing, and use of flameretardant materials.

Technology, scientific data, and analytics, working in concert, lend critical support to the development of increasingly sophisticated risk modeling tools, which can provide valuable insights into risk exposure and aggregation, informing risk mitigation, risk retention and risk transfer strategies. Identifying and quantifying potential losses from natural and human-caused catastrophes can be the first step in helping family offices determine the best ways to protect family members and their assets.

Cyber risks

Internet connectivity presents a diverse and growing set of strategic risks for family offices, touching not only individual family members but also the family enterprise and family offices' own operations. As a result, managing cyber risk has become imperative.

The 2018 MMA PCS Family Office Benchmarking Study found that 30% of family offices see cyber as the risk that has become more important in the past few years, and 23% believe it's the risk they are least prepared to deal with. Further, the FBI has tracked an increase in cybercrimes, such as business email compromise, ransomware and cyber extortion.

The growing number and sophistication of cyber-attacks are cause for concern, particularly among high-net-worth individuals and family offices. Digitization of operations adds convenience but increases vulnerability. A breach of personal data can become an enterprise risk. A cyber-attack using ransomware or other sophisticated means could shut operations down for weeks or months, with devastating financial consequences for a family.

Unfortunately, cybercrimes such as those described here are real and relatively easy to perpetrate.

Social engineering

An increasingly common method is to impersonate a family member or vendor, persuading the family office or domestic staff to transfer funds or make what otherwise looks like a routine payment. For example, a cyber criminal who obtained personal information about a family member who is traveling might request funds on the plausible pretense that the family member is buying a new boat or other asset. Unless the request is authenticated, the social engineering scam might succeed.

Weaponization of information

A disturbing development in cybercrime is the theft of or manipulation of sensitive information to publicly expose individuals and corporate entities. For example, "deepfakes," or technologically contrived images or voice recordings, are increasingly used to embarrass or shame high-profile individuals. The reputational and brand damage that can result from these incidents may prompt victims to withdraw from leadership roles in operating businesses or nonprofit organizations, curtail public appearances, or cancel commitments. In the age of social media, where any accusation can spread like wildfire, family offices must remain vigilant to protect family members. Useful techniques to combat these types of reputation attacks include monitoring of social media and the dark web.

Cyberattacks on the family office itself

In the past, cyber-attacks seemed to be a problem mainly for corporate entities. Now, however, family offices and high-net-worth individuals have been identified as soft targets for phishing, ransomware, and other cybercrimes. Increasingly, organized crime and state-sponsored hackers are targeting wealthy families. Most family offices are relatively small, anonymous organizations and typically rely on third-party information technology resources for IT maintenance and cybersecurity. Yet, the value of data that the family office holds is significant. Family offices must take precautions to safeguard sensitive information, such as data on direct investments as well as intellectual property related to the family's enterprise and holdings.

Cybersecurity is important for all family members — and household staff — no matter where they are and no matter what connected device they are using. In addition, family offices should have a cyber governance framework that includes communications, governing policies, and procedures for cyber preparedness and response as well as a person responsible for updating systems regularly. Family offices should explore their cyber insurance, crime insurance, kidnap and ransom insurance, and risk mitigation strategy options with a knowledgeable advisor.

From legacy to impact

Another prominent change is high-net-worth families' shift from a focus on legacy to impact. In the past, a common family goal was to preserve generational wealth. Now, however, more families are looking to create an impact on society across the family's activities – from the family enterprise, to direct investing and philanthropy – as an additional component to their financial legacy.

An example of this is The Giving Pledge, a movement founded by billionaires Warren Buffett and Bill Gates that encourages the world's wealthiest to commit half their wealth to philanthropy or charitable causes during their lifetime or through their will. As of 2019, more than 200 pledgers have joined The Giving Pledge.

Family office evolution

Complexity in family assets, macroeconomic and social trends, and generational differences are prompting an evolution in family offices. In an era of growing uncertainty, one of the biggest shifts among family offices is an increasing demand for information they can use to take action to protect families. That shift has ramped up family offices' expectations for professional advisors and made timely risk information critical indecision making.

As families' activities put pressure on family offices, educating family members about risks is becoming paramount. Family offices may not be able to prevent family members from doing certain things, but they can get them to pause and understand the potential consequences of their decisions. Family offices have established a strong position to gather and present the right data and insights to help inform families.

Other significant changes in the family office space are occurring, a movement toward what FOX calls "Family Office 2.0." Here are a few examples of this evolution:

Changing families

The traditional family model is evolving into modern, blended families. In the past, families were aware of generational transitions, but today many have three, four, or even more distinct generations spread out across broader geographies.

Risk management

Family offices previously served as the family risk manager, with a focus on known risks. Now, the family office is adopting a formal process to manage risks and opportunities for the family enterprise and preparing to manage unknown risks. The greater pace of change is accelerating this change in focus.

Changing family goals

Wealth preservation and a focus on leaving a financial legacy to subsequent generations has shifted toward the impact of family investments and preservation of the family's entrepreneurial enterprise. Furthermore, families that previously focused on giving in their local community are now taking a broader view of their social responsibility.

Closer advisor relationships

Traditionally, professional advisors provided historical reporting and tracking, on a delegated basis. Now, advisor relationships are marked by direct engagement with owners and more future-focused analysis. This approach brings with it new tools and a need for new talent.

Strategic risks are not the only concerns for family offices. Other exposures arising from risk convergence include personal risks, commercial risks, and financial risks.

Personal risks

High-net-worth families may range from a single household to more than 50 households and hundreds of family members. Each household may have a diverse set of personal property and liability exposures. Wealthy families often own multiple properties in varied locations around the world. In addition to international property risks, personal involvement in non-profit and philanthropic organizations, especially as a board member, can bring with them increased liability exposure. In today's litigious environment, families and high-profile individuals often are targets for lawsuits. It's important, therefore, for family offices to understand the activities and assets of each family member in order to ensure adequate protection.

Understanding claims frequency and severity are foundational elements in developing effective risk management programs. The majority (49%) of family office claims over a 10-year period are auto losses. However, home claims account for 57% of the total amount of paid losses. Although liability claims account for only 1% of reported claims, they account for 23% of paid losses.

Leadership liability

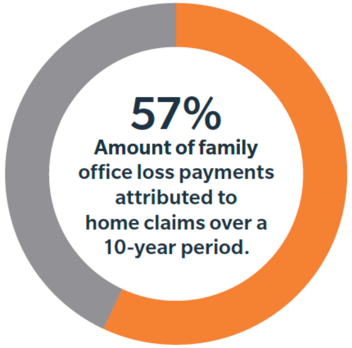
Family offices should pay attention to leadership liability, particularly the trend of increasing litigation against directors and officers of public as well as private and non-profit organizations. Many members of wealthy families contribute their leadership to non-profit and philanthropic organizations, serving as directors or officers. What family offices may not fully realize is the exposure these involvements can entail, particularly for directors' and officers' personal assets. Chubb cites studies showing that nearly 60% of non-profits have reported directors and officers liability (D&O) claims in the past five years, and nearly two-thirds of high-net-worth individuals are underinsured for non-profit D&O liability.[7]

The increase in D&O litigation is being driven partly by the #MeToo movement of victims reporting sexual misconduct and partly by concerns about the adequacy of organizations' data security.

Statistics on private company D&O litigation are scarce, though one metric is lawsuits brought by federal agencies. Since 2016, the number of lawsuits the US Equal Employment Opportunity Commission (EEOC) has brought against employers has increased steeply. In fiscal 2018, the EEOC received more than 7,600 claims of workplace sexual harassment.

For publicly traded companies, securities class-action litigation is continuing at a near-record pace, according to data from the Securities Class Action Clearinghouse (SCAC), a collaboration of Cornerstone Research and the Stanford Law School. Through the first half of 2019, the SCAC reported that the total number of filings, 198, was the fourth highest since the Private Securities Litigation Reform Act was enacted in 1995.

What this means for family offices is that family members have a significant liability exposure when they serve as directors or officers of public and private organizations.



Hosehold staff

A risk that straddles the line between personal and commercial involves high-net-worth families' household staff. Seventy-eight percent of families employ staff separate from the family office team. These domestic employees may assist families with a range of activities, such as elder care, child care, housekeeping, landscaping, general property management, chauffeurs, yacht captains and private aircraft pilots. These workers may have long-standing, close relationships with their family employers. Nevertheless, it's important for family offices to consider the risks that can arise when employing household staff and to make appropriate use of available legal structures to insulate the family from claims where possible.

Potential risks include:

Worker injury and illness

Ensuring safe working conditions is part of the duty of care employers owe to their employees, but accidents can still occur. Most states require employers with one or more employees to maintain workers' compensation insurance. Workers' compensation is the sole remedy in most jurisdictions for workers who suffer bodily injury and/or disease arising out of the course of their employment. State workers' compensation laws provide for stiff penalties against employers that allow their coverage to lapse.

Lawsuits

Despite close working relationships, disagreements can occur that lead even long-time employees to file lawsuits. For this reason, family offices should seek qualified legal advice as to the best ways to protect family members and their assets from litigation. A formal handbook for domestic employees, outlining responsibilities and working practices, is strongly recommended. In addition, family offices should consider purchasing employment practices liability insurance (EPLI). The Family Office Benchmarking Study found that only 58% of respondents reported having EPLI coverage, even though more than three-fourths of families employ staff outside of the family office.

Third-party liability

Domestic employees' activities in public that cause property damage or bodily injury can result in third-party liability claims against the family. This scenario can apply in various settings, such as private yacht and aircraft crew involved in accidents with hired or non-owned vehicles, or injuries caused by armed private security staff who discharge weapons in public.

Dishonesty

Domestic employees often hold positions of trust, which can make abuses such as theft more traumatic for family members. Thorough, consistent background screening and due diligence on all domestic employees as well as a system of checks and balances on employees' authorized activities are important. Due diligence should include a thorough review of state and federal court records, criminal histories, credit checks, bankruptcy searches, interactions with past employers, and social media activity. Even after hiring, a periodic review is recommended, as employees' circumstances and behaviors can change. It is recommended that family offices inform potential employees upfront and unapologetically that background checks will be updated annually as a matter of family policy.

Regulatory penalties

State and federal agencies enforcing various employment regulations have the authority to impose penalties for violations. For example, employers of live-in domestic workers must follow applicable tax, wage, and labor laws.[8] Additional requirements apply for foreign workers with visas.

Privacy and social media use

Even well-intentioned domestic employees can inadvertently expose families and their assets to unwanted attention. For example, a caregiver who posts a photo of a child's birthday party on a personal social media page might not realize the image shows a highly valuable piece of family property in the background. Family offices should develop formal policies and procedures on acceptable social media content and messages, not only for family members but also for those who work with the family.

> **"Addressing these risks can involve a combination of staff management procedures, compliance programs, and insurance solutions.**

Specialty Risks

In addition to a family's personal homes and automobiles, family offices may have a variety of specialty risks to consider, depending on a family's lifestyle. Collections of fine art, personal aircraft, private yachts, and other property all present different and complex exposures. Among the specialty risk issues to consider are:

Private collections

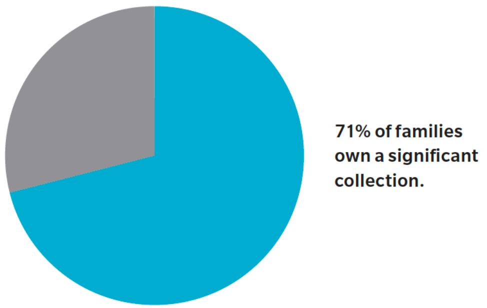
Among MMA PCS family office clients, 71% of families own a significant collection. By type, 50% represent art, 21% jewelry, 12% cars, 3% antiques, and 14% are another form of collectible property, such as valuable coins, stamps, musical instruments, and other items.

In protecting private collections, especially fine art, two key considerations are location and valuation. For example: Is the collection in one place or spread out in multiple locations, such as second homes or in storage? Whatare those locations' main exposures? How are the pieces protected from theft, catastrophe exposures, and damage in each location?

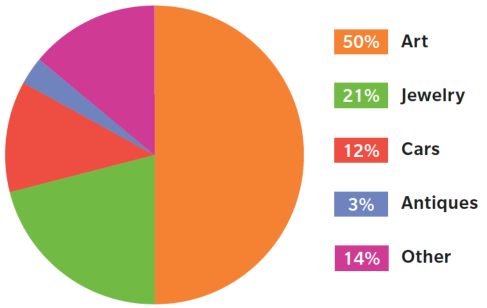
Families that collect fine art may have works from famous artists that seldom go on the market and therefore may need to have these pieces evaluated to ascertain that their valuations have kept current with the market. A continuing trend among collectors is to acquire works of contemporary and emerging artists, which can fluctuate in value. Periodic appraisals to keep valuations accurate are recommended, both for insurance purposes as well as cataloging of investment assets.

04 | Types of private collections

Significant Collections



Types of Collections



Other exposures that family offices should consider with regards to fine art include:

Provenance

Due diligence prior to acquiring art, particularly antiquities or pre-World War II art, is critical to ensure authenticity as well as free and clear title.

Transit

Even though art theft has captured the public imagination for centuries, a much more common source of loss is accidental damage while pieces are in transit. Using specialized art shippers, with equipment designed to safely transport fine art, is the best way to prevent unfortunate accidents and mishandling.

Pieces on loan

Some collectors generously loan their art to museums and other institutions. Contracts outlining responsibilities and coverages are strongly recommended to avoid disagreements and financial losses if damage or theft occurs.

Art as collateral

Many collectors find they can obtain favorable loans against the value of their art collection for investments or business ventures. It is important to work with consultants that understand this exposure.

Yachts

Twenty-two percent of families own at least one yacht, according to the Family Office Benchmarking Study. Private yachts come in various sizes, as measured in length and gross tonnage, and can range from sailing vessels to nearly the size of cruise ships, with luxurious features. In addition to hull and machinery exposures, new risks are emerging for yacht owners. These include:

Diverse watercraft

Yacht owners are constantly adding “water toys” and personal watercraft to their vessels, from tenders of various sizes to parasailing equipment, hydroflight jetpacks, and amphibious boats that can drive on land. Popular equipment commonly found on large yachts include personal watercraft and propulsion devices for snorkeling, scuba diving, or surface recreation. Amphibious boats, meanwhile, enable users to navigate virtually any beach, but they can also pose third-party liability risks while on land. Additional coverage can be added to yacht policies for amphibious operations on private property, but separate policies are required for amphibious boats to operate on public roads. Marine policies tend to have many exclusions relating to the use of additional equipment, making it important for yacht owners to understand their coverage options, limitations, and exclusions.

Unmanned aerial vehicles

UAVs, also known as drones, are becoming one of the most popular additions to a yacht’s equipment. Some owners like to use them for aerial video and photos, such as during sailing races, while others are employing larger drones that can carry objects such as cases of champagne from shore to ship. Aircraft exclusions often come into play in marine insurance, so it’s not a clear-cut case of having coverage under a marine policy when an owner acquires a drone. Some underwriters insist on gathering extra information and adding coverage endorsements for additional premium.

Marine cyber risks

Cyber exposures are not confined to land-based computers and networks. Satellite systems provide internet access anywhere on Earth, usually over privately operated networks, but cybersecurity is largely left to the user. Many yacht owners and crew access the internet for business and personal use while on board, so the impact from cyber-attacks or data loss can be substantial. At the same time, marine coverage options for cyber risks are very limited. The marketplace for marine-based cyber risks is still developing due to a lack of actuarial data.

Aviation

Family offices representing families that own aircraft are contending with exposures that are becoming more complex, as aircraft owners look to offset operating expenses through lease agreements and charters, and younger family members acquire new types of light aircraft.

Ultra-high-net-worth individuals around the world own private aircraft, with the largest number of such aircraft (13,392) in North America, according to 2017 data compiled by Statista. By comparison, ultra-high-net-worth individuals owned 2,795 aircraft in Europe, 2,596 in Latin America, and 1,186 in Asia-Pacific.

Owners of private aircraft, whether they are single-engine or multi-engine planes, turbo jets, or rotorcraft, commonly fly their aircraft for business and personal use. Demand for new business jets, for example, has remained fairly steady since 2013. Between 2013 and 2017, the most recent year for which data is available, an average of 692 new business jets were shipped annually, according to the General Aviation Manufacturers Association.

Aviation risk scenarios that are becoming more common for family offices include:

Time-sharing agreements with other families

Families that own aircraft with different ranges may arrange to share different aircraft for trips of longer or shorter durations as a way to reduce operating expenses. For example, a family that owns a plane with a range of 6,750 nautical miles for international travel might prefer to borrow one with a range half as long for domestic flights.

Lease agreements

Owners of private aircraft that fly their equipment less than 100 hours per year often lease out their aircraft for an agreed number of hours during a specific time period, to offset operating costs. Similarly, some clients lease other aircraft for their own use, such as a helicopter if they are taking flying lessons, before committing to a purchase.

Charters

Another popular method of offsetting aircraft expenses is to allow charters of private aircraft. This kind of flight activity requires Federal Aviation Administration (FAA) certification, known as Part 135. The FAA grants authority under the Part 135 certificate for on-demand, unscheduled air service and imposes additional requirements for training and handling of hazardous materials.

New types of light sport aircraft

A popular development in private aviation is amphibious planes. These are two-seaters powered by a single engine, able to land on both ground and water, with folding wings that make the aircraft easy to store and transport over land. They are popular with adventure-minded owners as well as those who may still be learning to pilot aircraft. As a result, aviation insurers are typically unwilling to offer high liability limits for these aircraft.

Unknown exposures

Family members sometimes acquire aviation equipment, such as drones, unbeknownst to the family office. Non-aviation policies tend to exclude drone activity or provide restrictive coverage, so it's important for family offices to understand today's diversity of aviation risks and ensure these exposures are protected.

Whether a family office is arranging a time-sharing, a formal lease agreement, or a charter, an essential consideration is coverage under the actual owner's insurance policy. Policies that provide coverage for "all operations of the named insured" can apply to an aircraft's use by other parties, but they might not appropriately extend coverage to a third party without special consideration. Working with risk specialists can help family offices arrange tailored coverage terms to better fit the full range of specialty personal risk exposures.

Personal security and travel

Every year since 2009 has seen steady increases in international travel, particularly for long-haul visitations, according to the US Travel Association. This trend raises several issues related to family members' travel practices and personal security, including:

Cybersecurity

This has become a major threat for family offices to consider, and it goes hand in hand with physical security, no matter where a family member may travel. Cyber-related risks in travel include accessing the Internet via public Wi-Fi networks that may be unsecure and potential loss of communications due to cyber-attacks on infrastructure.

Threats from the public

Among high-net-worth families, travel using private conveyances is often preferred to commercial aircraft and public transportation, but when that is not possible, family members can increase their safety by avoiding spending too much time at common spots of vulnerability. These include "chokepoints," such as ticket counters and security checkpoints. Using private lounges or other areas with restricted access while traveling can provide an additional barrier. According to the Federal Bureau of Investigation, more than 60% of active-shooter incidents in 2018 occurred in commerce-related settings.9 Over the past several years, multiple shootings have occurred in unsecured areas of public airports.

Travel to underdeveloped areas

More high-net-worth individuals are traveling to and acquiring properties in underdeveloped countries. These activities raise a number of concerns, such as the potential for crime; low-security public internet access; and vulnerability to natural disasters, terrorism, and public protests. Despite the attention that kidnappings and ransom demands receive, family travelers are more likely to experience a medical event requiring evacuation. Planning for unexpected events, whether natural disasters, civil unrest or medical emergencies, is a critical step to ensure that family members can quickly get to safety or obtain their preferred medical care. Usually in residential settings, physical security takes the form of intrusion detection, access controls, and closed-circuit television monitoring systems.

A relatively new tactic in physical security planning is the development of "safe" corridors, areas within a residence where family members can escape threats or take shelter during severe weather or other life-threatening events. Another important consideration in physical security risk management is ensuring that computer equipment, cables, and systems are properly protected and secured.

A thorough review and assessment of security programs and procedures can identify gaps and areas for improvement. Family offices can help make families safer by partnering with security experts and making contingency planning a regular part of travel-related activities. Working with a personal risk advisor can also help ensure appropriate policies – such as cyber or kidnap and ransom – are in place and properly structured to respond to risks while traveling.

Commercial risks

Many family offices administer wealth created by a family enterprise and its operating businesses. These families have experience in owning and operating successful businesses and may even have founded the leading public or private companies in their respective industries. As a result, the convergence of risk for family offices often will involve commercial risks.

The range of risks that corporate entities face therefore can affect families that own, control, or participate in them. These risks include property damage from natural or manmade causes; liability for financial losses arising from third-party property damage, environmental impairment, and/or bodily injury; directors and officers liability for governance actions that may harm investors; liability for errors and omissions in professional services businesses; fiduciary liability for errors and omissions while responsible for employee benefit plans; reputational risk/brand impairment; cyber liability; and many more.

Sophisticated corporate entities usually have formal departments and skilled individuals dedicated to managing operational risks. Family offices can learn from this approach in managing the risks to families' operating entities, whether small businesses, nonprofit organizations such as foundations, or large operating companies.

Keys to managing commercial risks in family offices include:

Data gathering

Making informed decisions about commercial risks requires a constant flow of risk data. Family offices need to establish and maintain processes for capturing exposure and loss data. Unpleasant and often costly surprises result from belatedly learning about a risk exposure.

Risk governance

Good risk governance integrates risk management and strategic planning, and reflects the goals and needs of the family as well as the enterprise. For example, family foundations and other non-profit organizations can still be targets for lawsuits. Family offices need to consider appropriate protection for not only those entities but also individual directors and officers.

Treating investments in operating entities as businesses

Family members commonly pursue personal projects by investing in a corporate entity. Even if the entity is small, the family office should consider it a business for purposes of risk management and insurance.

Objective advice

The most successful corporate risk management teams rely on professional advisors for objective advice, analysis, and risk modeling to inform their decisions about risk avoidance, mitigation, retention, and/or transfer.

Understanding boundaries of insurance programs

Commercial lines insurance policies generally do not extend to personal activities, making it important for family offices to understand where coverage may begin and end for family members' varying roles. A common misconception, for example, is that corporate cyber insurance will respond to a breach of family members' personal data. Likewise, a commercial automobile policy may not cover an accident that does not arise from business use of a company-owned vehicle.

In addition to the strategic risks, personal, and commercial risks that a family office must consider, emerging financial risks can require a significant amount of attention.

> **"Family offices can learn from sophisticated corporate approaches in managing the risks to families' operating entities, whether small businesses, nonprofit organizations such as foundations, or large operating companies.**

What family offices should look for in a risk manager

Family offices that want to strengthen their approach to risk management can emulate traits that define strategic risk management organizations. Research conducted by Marsh Risk Consulting on "What makes a best-in-class enterprise risk management (ERM) organization?" identified leading indicators of organizations that have successfully embraced and implemented a Chief Risk Officer (CRO) role with ERM-centric approaches to the traditional risk function.

The following traits and strategic approaches are common to CROs and enterprise risk managers:

Senior management support

The CRO/enterprise risk manager has a seat at the table and is a proven strategic thought leader, with a clear, direct line to the C-suite, and proven decision-making authority.

Communications

He or she is an effective and strategic communicator in all forms: written, oral, facilitator, and presentations both internally and externally, and speaks on leading topics of risk with authority and knowledge.

Reports

The CRO effectively reports complex information – up and down the organization, and balances technical details with management-level information.

Workflows

Clear and articulated risk management workflows drive ERM best practices. All line-level staff support a culture of risk management and follow standard protocols.

Personnel

The CRO has optimal people management skills and is a genuine team builder, able to manage up and down the organization.

Technology

He or she leverages technology and innovation and stays abreast of leading ways to incorporate technology into overall best practices for risk.

Data

The CRO understands that knowledge comes from effectively managing data and is skilled in leveraging data models and trends.

Process

He or she is process-driven, and leads and collaborates effectively, leveraging proven management processes.

Benchmarks

The CRO understands and balances the need and relevance of the benchmarking exercise and leverages benchmarking to advance strategic initiatives.

Family offices can use these traits and approaches to help families think about risks more strategically and to augment the family office's capabilities.

Financial risks

One of the fundamental roles of a family office is to assist in the management of wealthy families' assets, including investments. Since the global financial crisis ended in 2009, two key trends have emerged among high-net-worth families: direct investing and impact investing.

Direct investing risks

Before the financial crisis, many families' investment strategies used an "institutional-type portfolio" approach. Such institutional investing approaches created diversified portfolios with high allocations deployed into funds focusing on private equity, hedge funds, and other vehicles with low liquidity.

Although such approaches are still used, affluent families are increasingly interested in direct investing in other assets, sometimes as co-investors with other families. A survey conducted by Knight Frank on ultra-high-net-worth individuals' attitudes toward investing in certain types of assets showed that 62% had increased their exposure in 2017 to equities, 56% invested more in property, and 46% allocated more to cash holdings. Among assets traditionally associated with institutional-type portfolios, 45% had increased their exposure to private equity, 38% in alternative investments, and 30% in bonds.[10]

Private equity and alternative investments, by their nature, are less liquid. Families that lead co-investing ventures with other like-minded families or individuals may unintentionally take on the liability exposures of a PE fund's general partner. That means a family may be fully liable for obligations to all participating investors, and not limited to the value of its own investment.

In addition to this risk, family offices should consider other types of risks that can accompany families' increased appetite for direct investing. For example:

Investment knowledge

Families whose wealth stems from a successful business may have intimate knowledge of a specific industry and therefore are strongly positioned to understand further direct investments in that sector. Sometimes that knowledge can lead families to take on more risk in niches they know well. But some families may lack such deep knowledge for the investments they want to make. That creates challenges for family offices, which may have to consult outside expertise to inform the family's investment decisions. A family that leads a co-investment consortium, for example, might be deemed the general partner (or the equivalent) and held liable for selecting and/or managing the investments.

Transaction risk

The risks that can derail or devalue a merger or acquisitions are numerous. For example, an overstated asset value, a latent liability, or an unforeseen tax bill, can sneak up on investors.

As the value of global mergers and acquisitions continues to climb, interest in transactional risk insurance has soared, especially as sellers look to eliminate or reduce the contingent exposure related to divesting. Transactional risk insurance policies are available to solve seller indemnification issues, and include coverages such as representations and warranties insurance, tax indemnity insurance, and contingent liability insurance.

In 2018, transactional insurance limits placed grew by 35%, to more than $36.5 billion, according to the Marsh JLT Specialty Transactional Risk Insurance Report.11 Private equity firms accounted for 55% of transactional risk insurance placements in North America in 2018, but the number of corporate and strategic buyers of the coverage remains strong and is growing worldwide, according to the report.

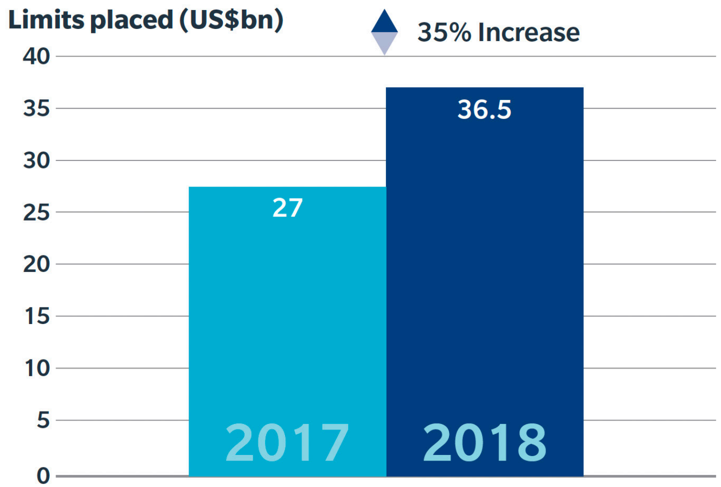
Another consideration for family offices is the family's exit strategy. Even when a family intends to maintain a holding for the long term, a clean exit after achieving the investment objectives is important to protect the value created. Latent exposures with long-tail liability, such as environmental impairment, can be covered through buyer-side and seller-side insurance solutions.

Due diligence

Best practices have been established and refined in the past several decades by private equity funds and other strategic institutional investors. Family offices should adopt such practices to thoroughly analyze prospective investments to identify problems that can erode value. Such analyses can help inform investors' decision making and provide confidence in pursuing an investment — or declining an opportunity.

05 | Limits and number of deals increased by more than a third, while average enterprise value also increased

Source: Marsh JLT Specialty



> “Families that lead co-investing ventures with other like-minded families or individuals may unintentionally take on the liability exposures of a private equity fund’s general partner.

> “Family offices can be caught in the middle of divergent family views. Advisors can play a critical role in helping families to break through these issues and move forward with clarity and focus.

Impact investing risks

A trend in investments that has skyrocketed in the past several years is impact investing, alternately referenced as sustainable, responsible, and impact (SRI) investing or socially responsible investing. SRI considers the environmental and/or social impact, or governance relating to a given investment. Impact investing differs, in that it aligns investments with the investors' mission. For example, SRI might avoid investing in fossil fuels or tobacco, while impact investing might focus on expanding low-income housing in a target community.

Of the US$46.6 trillion in professionally managed US assets in 2017, US$12 trillion — more than 25% — were in SRI assets, according to the US SIF Foundation.[12] Since 2016, SRI assets have increased 38%. The US SIF Foundation has tracked family office investing since 2012 and reports that the environmental, social, and governance (ESG) criteria for both single-family and multi-family offices have shifted over time. For example, in 2018, family offices emphasized community investing, whereas in 2016, their focus was more on environmental criteria.

The top five ESG criteria for family offices in 2018, according to the US SIF Foundation, were: small and medium size businesses, microenterprise, community services, climate change/carbon, and clean technology. Impact investing can be a core part of family foundations and endowments, or separate from philanthropic activities. In both cases, more families are pursuing impact investing strategies.

Younger investors are increasingly focused on ESG criteria, but growth in impact investing is not necessarily a generational phenomenon. A survey by the Morgan Stanley Institute for Sustainable Investment found that more investors are expressing interest in SRI investments. In 2017, 75% of investors overall and 86% of Millennial investors, were somewhat or very interested in sustainable investing, and both increased from a similar survey in 2015.[13]

Due to the nature of impact investments and differing investment philosophies among family generations, family offices need to think about and should seek expert guidance on the following risks:

Investment governance

Good governance in investments begins with understanding the family's primary objectives, risk tolerances, investment horizons, values, and expectations. Once those are known, the family office can screen investments and allocate capital accordingly, with an eye to mitigating volatility and erosion of principal assets. In impact investing, it's also important for the family office to know how the family defines impact and success, to measure the performance of those investments. For some types of impact investments, no benchmarks may exist, making it difficult to quantify performance.

Divergent objectives

Family generations may have vastly different philosophies on investments, as well as differing risk tolerances. For example, a founding generation may have a higher tolerance for downside risk as it builds wealth, whereas second or third generations may focus on preserving the longevity of an asset, and therefore prefer less risk. In addition, multigenerational families that are spread geographically often have different ideologies. One household may deem certain causes or investments to be a higher priority than another household. Family offices can be caught in the middle of such differences, without a clear idea of how to reconcile divergent family views. Advisors can play a critical role in helping families to break through these issues and move forward with clarity and focus.

Mission shifts

When families disagree on long-term investment philosophies, there is a risk of shifts in the family's philanthropic mission, which can be accompanied by shifts in endowment assets that support that mission. For example, a founder's vision might focus on one or two objectives for a family foundation. Over time, succeeding generations might add different objectives, some of which could eventually conflict with the original mission, allocating funds away from the foundation's original purpose. This is a difficult challenge for a family office. Family education on financial literacy and fiduciary responsibility, especially for rising generations, is paramount. An important role that family offices can fill is to help families make informed investment decisions and consider strategic questions, such as "How can we maintain a common philosophy?" and "How should we address members' competing investment priorities?"

Whether a family office is considering a family's direct or impact investments, a clear understanding of the investment objectives, the family's risk tolerance, and how to measure the investments' performance is important. Working with expert investment advisors experienced in SRI and impact investing can be prudent to help identify and structure investment opportunities that are appropriate for the family's objectives.

A holistic approach to managing risk

The complex, convergent nature of risks facing high-net-worth families requires family offices to adopt a different approach to risk management than many have in the past. A holistic approach, using data, science and analytics to inform decisions and educate family members, will be important in managing global risks.

Family offices vary greatly, as do the families they represent, but they have a common dislike: unpleasant surprises. Getting ahead of risks requires a strategic approach to identify exposures and develop plans to mitigate or avoid them. New risks continue to emerge, but family offices can manage them with the right team and specialized expertise.

From the overarching trends of growing families and wealth expansion, to increasing frequency and severity of natural catastrophes, to the affiliated risks of personal, commercial, and financial exposures, family offices that apply a strategic perspective will be best positioned to successfully navigate these challenges.

Endnotes

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