FIXING LEAKY PIPES: A SOLUTION FOR INTERGENERATIONAL WEALTH TRANSFER

CAPCO

OVERVIEW

Whether we like it or not, we're getting older. The number of Britons over the age of 90 has almost tripled since the early 1980s. More people are waiting until their 50s, 60s and even 70s before they inherit their parents' wealth. After all, even Prince Charles at 69 is still waiting to take on the crown!

Effective financial planning aims towards maximising the contribution of every pound in one's financial portfolio. An example of this could be the implementation of a 'gifting' programme during retirement, which slowly and judiciously moves one's surplus assets to the next generation helping the beneficiary avoid a significant inheritance tax (IHT) bill upon receipt of that money.

We are seeing an upward rise in intergenerational wealth transfer. One research estimated that the figure for 2017 has already crossed £69 billion and in 10 years' time, it is expected to increase to £115 billion[1] annually. Further studies indicate that future generations are more likely to receive an inheritance than their predecessors: 75 percent of those born in the 1970s have received or expect to receive an inheritance, up from 55 percent of those born in the 1950s.[2] Over the next 30 years, we will continue to see this figure ramping up significantly, and potentially skipping a generation to directly benefit the Millennial generation (i.e. those currently between the ages of 25-34).

Yet today's financial planners, investment managers and family offices struggle to implement an intergenerational wealth transfer service as a key part of their service model. As a result, they are losing valuable assets and letting relationships slip into the hands of more digital savvy market entrants, who know the requirements of their digitally savvy customer base – a phenomenon this paper refers to as 'the leaky pipe'.

With new technology, Open Banking, PSD2 and changing attitudes towards savings and wealth, we see substantial opportunities for wealth managers to continue to provide profitable family-wide financial planning in tandem with robust regulatory expectations.

HOW BIG IS THE PROBLEM OF THE LEAKY PIPE?

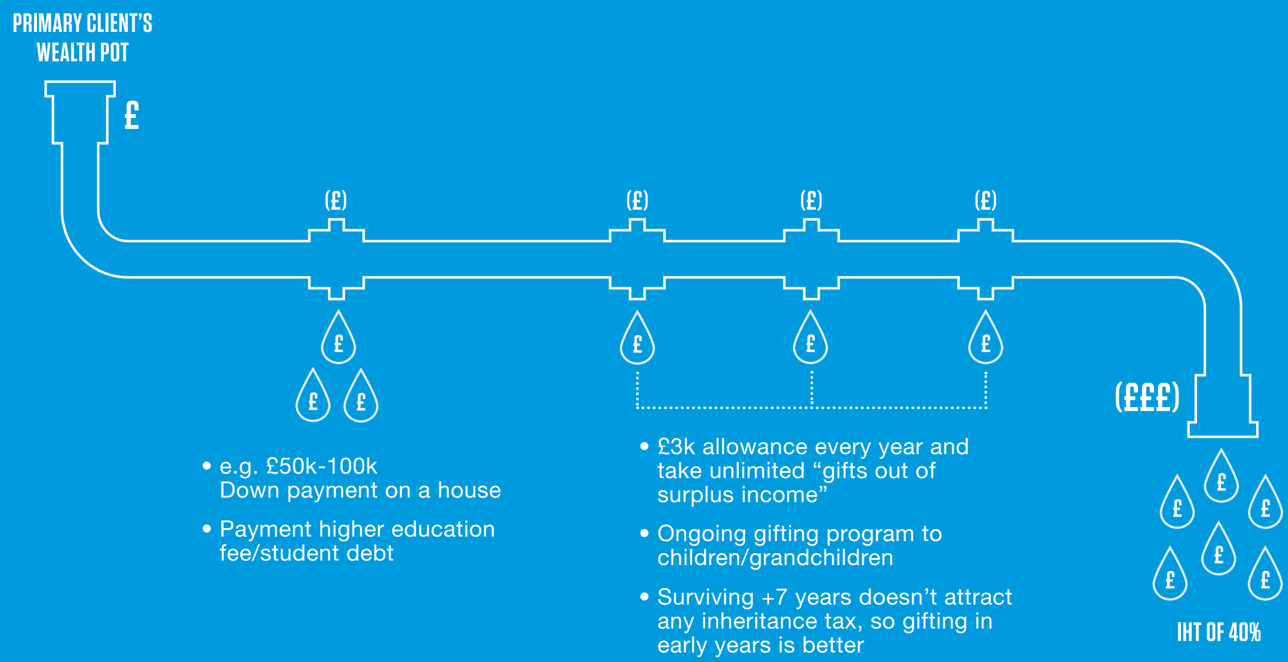
"Nothing can be said to be certain, except death and taxes" said Benjamin Franklin. The sentiment of this statement feels just as apt over 200 years on, with HMRC in May 2017 reportedly collecting £5.1bn of tax revenue from inheritance.[3] This statistic further shows that approximately 40,000 families paid inheritance tax (IHT) in the 2015/2016 tax year.

The reality is that many wealthy investors and retirees have more income generated from their pensions schemes, investments and businesses than they really need. Some wealth managers are now using cash flow modelling techniques or lifetime forecasting tools to pin point the amount of IHT that could be saved, by transferring wealth and implementing a well-structured gifting programme. Despite this, what adds to the leaky pipe phenomenon is that even after minimising IHT and maximising wealth transfer, the wealth manager still runs the risk of losing the underlying funds under management. The beneficiary could spend it all or re-invest into the financial markets, outside the control of the family or the wealth managers. This can be mitigated, by attempting to extend financial planning services to not only primary family members, but also their future generations.

> **"Nothing can be said to be certain, except death and taxes."**
>
> Benjamin Franklin

[1] http://inheritanceeconomy.co.uk
[2] Hood, A. & Joyce. R (2017) Inheritances and Inequality across and within Generations report, ifs.org.uk
[3] Telegraph Financial Services (2017) Inheritance tax receipts at record high, telegraph.co.uk

Figure 1: Wealth transfers numbers are increasing, but there is no way of knowing this fact



Wealth managers face a great operational hurdle in identifying the quantum of outflows, given the assets that get withdrawn out of a primary family member's accounts every year are not tracked. Overall, the operational systems and management information simply refer to this as 'withdrawals' or 'outflows, which could be to the tune of 5-10 percent of assets under management. For wealth managers, the operating model often doesn't deal with something as fundamental as linking family accounts on platforms therefore gaining insights into the broader family's assets so as to service the entire family wealth and apply fees holistically.

As Figure 1 shows, there is no structured way for wealth managers to service the money going out when it takes the form of a deposit on a first home, pays for university fees or pays off student debt. Increasingly, however, grandparents (Baby Boomers) and parents (Generation Xers) are looking to set up investment programmes – where they top-up Millennials' savings and investment accounts, much like a workplace pension, anywhere from £100 to £2000 a month. Overall, these savings and investments could amount to £14,000-£275,000 of assets over 10 years – building up even more significantly over time with the effect of compounding.

These pots are now being targeted by new Fintech entrants (such as Moneybox, etc), who are aiming at digital savvy Generation Xers and Millennials, with easy to use online services for micro-investing with entry thresholds as low as £1. **Whilst some wealth providers baulk at such paltry sums of money, it is worth remembering that both these generations will potentially build and inherit large sums of money over time.**

From a proposition and pricing standpoint – and counter to most heuristics prevalent in the industry – every single member of the family doesn't have to be profitable – it is the whole relationship that counts, now and in the future.

As aforementioned, what could make matters worse is if these outflows – such as one-off gifts or the next generation's investment programmes – don't get recorded on their way out, even after an in-house suitability report has recommended a gifting programme.

It's a leaky pipe with no measure of how much the drip is and where it's going!

MILLENNIALS AND THEIR ATTITUDE TO MONEY

Today, gifts tend to go to the next generation or alternatively, straight into the hands of Millennial grandchildren. It's unsurprising that beneficiaries in their 20s or 30s will have a completely different way of dealing with financial firms than their parents or grandparents. In the United States, for example, 66% of children reportedly fire their parent's adviser after they receive their inheritance.[4] This trend seems to be spreading across the globe too.

Based on our research on Millennials, we see the following themes:

Why isn't this on my phone again? ComScore notes that 91 percent of UK Millennials own a smartphone and spend between 2-3 hours a day on their mobile device.[5] A proposition that is not accessible online – when their personal banking almost certainly is – will be incongruous with their daily lives.

24/7 access: Millennials have access to knowledge through a variety of online mechanisms – newsfeeds on social networking sites, live chats, chatbots, etc. Waiting for an annual "suitability" meeting with a financial advisor is an alien concept, therefore.

Ethical investments: Millennials are paying attention to investing in socially responsible programmes and want to measure the socio-economic impact of where they invest.

Home ownership: Millennials are less likely to be homeowners than previous generations, which could affect their views on savings and investments.[6]

Spending vs. Saving: A study recently found that Millennials are more likely to consider themselves as spenders in comparison to Baby Boomers.[7] It also indicated that a majority of Boomers (78%) believe in starting to save at a young age; while a smaller majority of Millennials (60%) feel the same. There is a real need for financial coaching for families and Millennials to promote saving and investment and curtail the notion that the 'state will provide' – consistent with government policy of encouraging savings worldwide.

ADVICE IS STILL ADVICE, NO MATTER WHO THE AUDIENCE

While advice can be catered to the holistic needs of a family, a single point of advice must be judged by its own merit. This is what the FCA articulated in their 2015 report on 'simplified advice'.[8]

We see some wealth managers increasingly putting away intergenerational wealth transfer into the 'too difficult to deal with' box. The myriad of definitions around 'simplified advice' & 'focused advice' is confusing, but the underlying principles of good customer outcomes wins the day!

To service the younger and less affluent generations a handful of wealth managers are building digital and automated advice services into their overall proposition using low-cost, passive multi-asset funds as investment solutions. Unfortunately, these automated services can increase the risk of 'systemic' failures for a wealth manager if the advice algorithms aren't configured properly.

On the other end of the spectrum, the traditional face to face advice model, although excellent at building trust and future relationships, may not be a commercially attractive means for wealth managers to service the entire family's needs. We feel it needn't be this complex or even within the same service of comprehensive financial planning.

[4] Robaton, A. (2016) Preparing for the $30 trillion great wealth transfer, CNBC.com
[5] Lipsman, A., et al. (2015) The Global Mobile Report, comScore.com
[6] The Council of Economic Advisers (2014) 15 Economic Facts About Millennials, Whitehouse.gov
[7] Ameritrade (2016) Millennials and Money Research report
[8] Financial Conduct Authority (2015), Finalised Guidance: FG15/1: Retail Investment Advice report

DO WE FIX THE LEAKY PIPE WITH PLASTERS OR DO WE REPLACE IT?

We think the response is a combination of tactical fixes and strategic transformation of the business model. A capital expenditure of several million pounds to build a comprehensive digital advice model connected to a firm's current non-cloud enabled technology systems may not carry favour in the boardroom, given it's difficult to even quantify the size of the leaky pipe.

In this section, we outline our considerations against a five-step framework which combines our core pillars of data, proposition, digital & regulation.

Step #1: To put it simply, **know your family**. Record every piece of information you have about the client and their wider family onto a good CRM system and assess it. This could be data from client relationship managers or through various open data sources (with client consent and keeping GDPR in mind, of course). Collectively, this data will help to build a more robust view of the wider family and everyone's individual needs.

Questions to ask yourself are:

- How well do we know the primary family contact, his/her family needs and their complex network of relationships across my organization?
- What are the family members trying to do with their money and what liabilities/expenses are they all trying to fund?
- Do we have a client relationship management tool to map the family links in one place?
- Are the separate client accounts linked into one family account on the investment platform?
- How is the wealth distributed across the generations?
- What is the strength of our relationship with each member?
- What is their social media profile telling us?

The knowledge may reside in the minds or notebooks of the client relationship manager. As aforementioned, it is crucial that this information is in CRM or the practice management system. With GDPR arriving in May 2018, there is a dual benefit too: the client's personal information will be retrievable upon their request and it will allow wealth managers to do further analysis on a proposition potential.

Step #2: Understanding the potential IHT outcome is a win-win for a strong relationship with a client. Firstly, **calculate the potential IHT liability on the estate of the primary family member and then conduct an asset liability matching exercise.** Cash flow planning identifies the excess income and assets that can be gifted on a regular basis by the primary family member. A similar exercise examines the expenditure and savings needs of the next generation. The gifting programme can match the excess income arising from personal and business assets of the primary family member to the liabilities and saving needs of the wider family members. The wealth manager can match the liabilities not only by using annual allowances and a series of potentially tax-exempt transfers but also using the regular 'gifting out of normal expenditure' rules.

Additionally, modelling could be used to generate some value add discussions. All too frequently retirees live in a large family home paying for its expensive upkeep and running costs and incurring large IHT labilities when sold by the executor on their death. Releasing cash by downsizing and/or drawing down the capital from the house during their lifetime enables the primary family member to support the next generation earlier and when they need it.

Step #3: The customer lifetime value (CLV) of the entire family – which calculates the value of the fees paid for more than four years by all members of the family is a better way to convince oneself of the commercial case behind servicing the intergenerational wealth. Gross contribution per member can vary a lot, but a lifetime value provides a more cohesive way of planning this out. More than just the assets, the key is to have the whole family relationship stay on the wealth manager's platform.

Step #4 is to make sure the overall advice can stand any regulatory scrutiny. Hence, the overall solution **should pass the regulated advice and personal recommendations test.**

Different members of the family have different needs. As the Figure below shows, younger members typically need help with product decisions and simple investment advice, whilst the older generations invariably require more technical financial advice and holistic wealth planning.

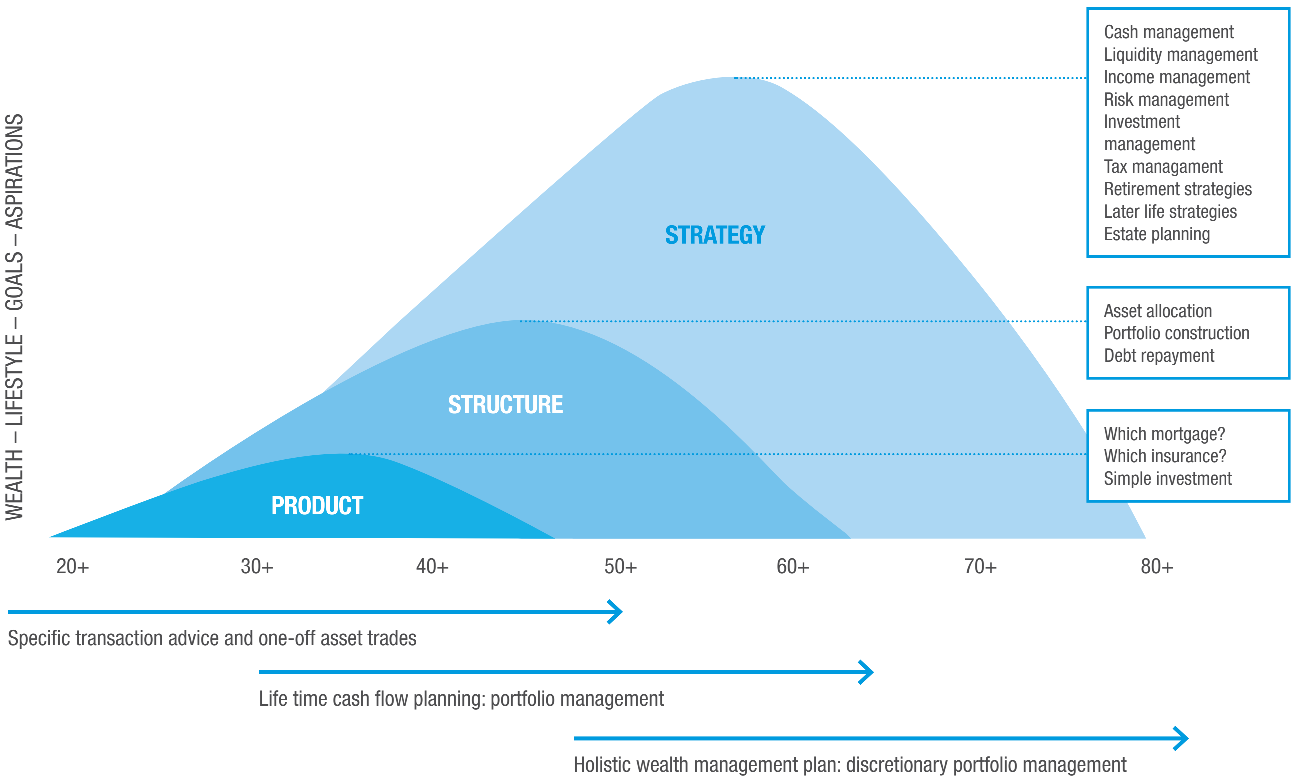
Advice also can be provided quite easily under the new regulatory regime. The updated streamlined advice framework from the Financial Advice Market Review in 2017[9] promotes the delivery of propositions to serve a simpler range of customer needs.

Streamlined advice services might include automated, 'robo advice' offerings or more traditional face-to-face or telephone-based models; however, it is possible to automate advice in a way that passes regulatory muster and more importantly, provides a value added service to Millennials in the family.

It is important to continuously monitor the advice algorithms, especially if there are automated digital propositions as part of the offering. This also includes due diligence on the full network of the third-party relationships, the referral network and robustness of the underlying platforms.

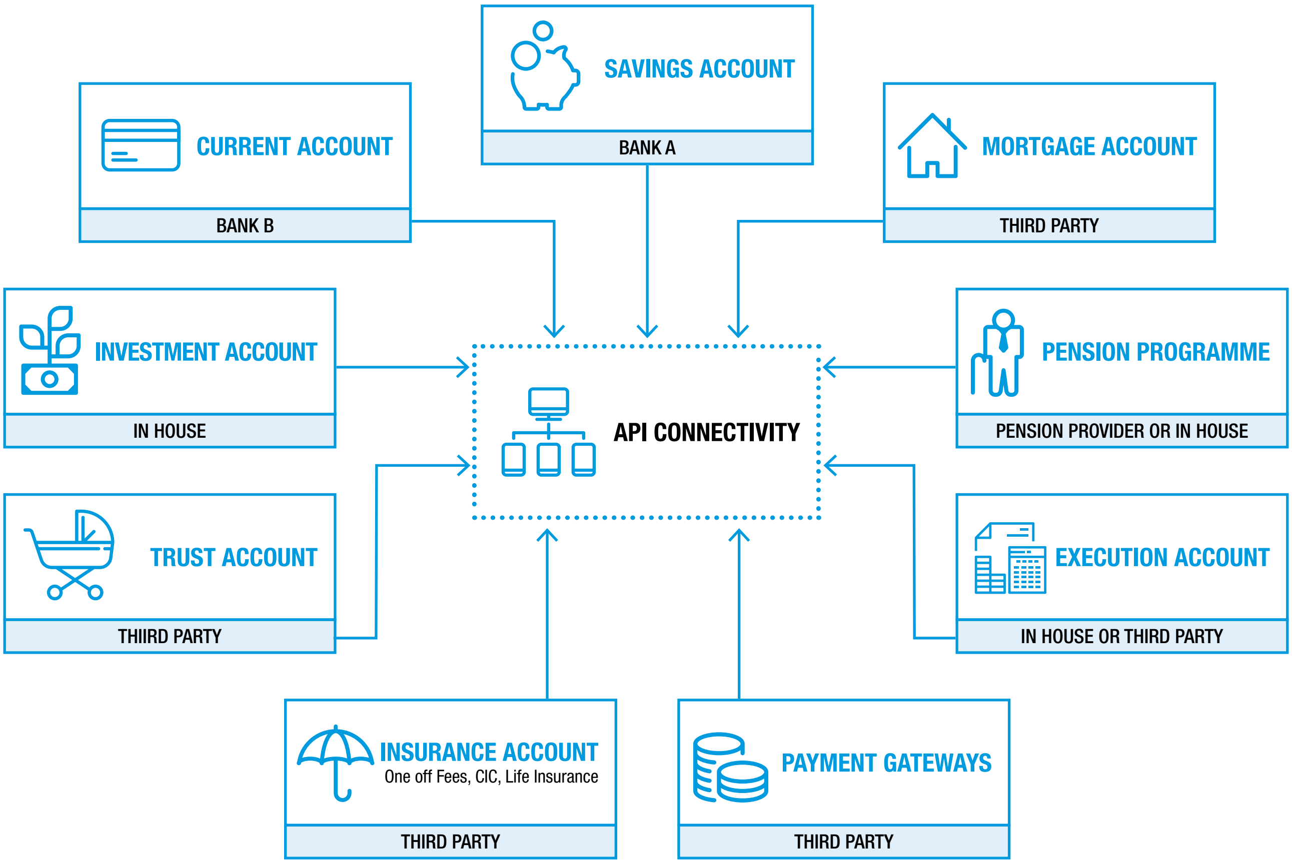
If proper intergenerational transfer were to happen, automated advice should be viewed as advice and not guidance augmented with a regular contact strategy to enable a firm to build a trusted and enduring relationship with the younger generation.

Step #5: Finally, this last step involves delivering the best of the firm's propositional and technology services, i.e. **delivering a packaged service**. It is important that wealth managers consider the relationship and trust with the primary member and their next generations as a holistic family service including a family pricing model and financial coaching for the Millennials so they build knowledge and experience.



[9] Financial Conduct Authority (2017) FG17/8 Streamlined Advice and Consolidated Guidance, fca.co.uk

Its all within a family...



If some of the solutions aren't available in-house due to cost or effort constraints, wealth managers should consider partnerships with challenger banks and digital entrants. The key is that the whole family should see the wealth manager as the primary liaison, who provides breadth and flexibility in the offering to meet their needs; mitigating the leaky pipe phenomenon.

To enhance the operational and technological ability of the firm to cater to an overall family service, we think wealth managers should embrace the onset of Open Banking, PSD2 and the challenges and opportunities thrown up by building API connectivity across the various inter-connected savings and investment accounts, as illustrated in the diagram above.

We are already seeing a rise of the use of 24/7 chatbots and financial education within a suite of digital propositions – including wealth management. Additional transparency and underlying investment data provided by online tools can provide Millennials with the ability to understand the social and ethical impact of their investments.

It's time to fix the leaky pipe. As we continue to see Millennials receiving substantial sums of wealth - either through tax efficient gifting or large inheritances over the next 30 years – a holistic, intergenerational service from a wealth manager will go a long way to sustaining the familial ties that this industry has proudly built itself upon.

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