By **Warner King Babcock**

How to Properly Structure and Govern a Family Bank

It's a unique way to fund and support the next generation

High-net-worth families and those who own businesses and want to plan for the future encounter several challenges and opportunities, including:

1. Financially assisting the next generation without causing problems;
2. Inspiring the next generation to build intellectual and financial wealth;
3. Developing accountability, perseverance, responsibility and self-reliance in the next generation; and
4. Inspiring teamwork and building meaningful relationships.

The solution? These families should consider allocating capital to a special family-created entity as a corporate vehicle in addition to a trust. The entity's purpose is to directly fund and support the development of the next generation through intra-family financing—a family bank.

What's a Family Bank?

A family bank is a family business that's specifically formed for the purposes of providing family funds to family members, otherwise known as "intra-family financing." Financing the next generation can be in the form of loans, equity or a combination. Family banks aren't commercial and regulated, so there are no accounts, depositors or funds made available to the public. A family bank can provide a source of funding to family members or their related entities, which is much more flexible and customized than traditional commercial, regulated bank financing. However, the terms need to be within the Internal Revenue Service rules and accompanied by proper documentation for tax purposes.

Use of a family bank can help build the next generation's human, intellectual and financial capital, as well as their accountability, careers, entrepreneurial spirit, perseverance, responsibility and self-reliance, all while maintaining and building strong family relationships.

Family banks can (and should) generally start small and provide nominal, simple loans to young family members to instill basic financial responsibilities. A family bank can also offer or require educational sessions for next generations to develop a better understanding of the issues, requirements and practices that will guide them to success. Reducing mistakes can make the experience more enjoyable. Senior and other experienced family members, along with outside mentors or advisors can share their wisdom on an on-going basis as the next generation plans, proposes and builds their funded projects.

The earlier the next generation is involved with becoming financially educated, the more likely that they'll be able to build the intellectual capital necessary to manage their own careers, assume greater roles in and grow the family wealth and the family business. The global financial crisis taught many families that they need to pay attention to how their wealth is managed, allocated and spent, as well as the importance of preparing the next generation.

Finally, but in many ways most importantly, a well-run family bank can introduce and promote integrated, healthy governance systems in the wider family. (See "Family Governance and Family Banks," p. x.)

Let's look at the four challenges and opportunities mentioned above and how a properly structured and governed family bank can help address them.

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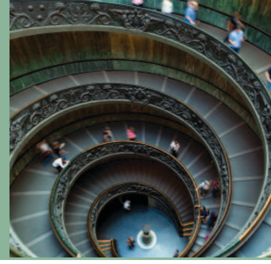


Financial Assistance

Good family governance with independent judgment and oversight should be used when making funding decisions. Family emotion, a single controlling trust or individual or a party with a bias or conflict of interest shouldn't drive decisionmaking.

Good governance and planning is at the heart of a successful, sustainable family bank and key to building healthy family relationships. The family should work with experts to: (1) determine what the true purpose, size and nature of the family bank should be, (2) create clear governance structures and policies, (3) develop financing criteria and processe policies, and (4) form an independent governing body, such as a board of directors or advisory board, with or without an investment committee, to review and approve each financing proposal made by the family members.

These independent parties can also provide objective advice without emotion. However, it's important to have the next generation involved in the creation and decisionmaking of the family bank, democratizing it. If it's not relevant or of interest to the next generation initially or over time, the family bank will fail. All criteria, processes and policies for funding should be open and well communicated in advance, based on questions such as: Who can apply for funds? How much funding is available? What funding purposes are allowed? Who will judge the strength of the application? Who will monitor the use of the funds? What general terms might apply, including a repayment schedule? The activities and performance of the family bank should be reported periodically to help all family bank owners and participating members determine the value of their interests and eliminate suspicions. All these above steps help build a healthy bank entity and healthy intra-family relationships.

Inspiration

By definition, the family's current wealth has its origins in someone's entrepreneurial efforts. All families can tell the story of "great-great-grandpa" who came to the new country with nothing but some cloth to trade. Due to his tremendous hard work, perseverance and entrepreneurship (and some luck from time to time), he created the family's wealth. Now what?

Merely protecting wealth today is to watch it decline. Further, without the continued development of human and financial capital, the wealth or family enterprise that "great-great-grandpa" built won't be sustainable across generations. At the same time, it's likely that the number of individuals joining the family is increasing. The result is less wealth and fewer family business jobs to be divided among more people, many of whom may become dependent on or feel entitled to the wealth.

> Entrepeneurship can play a key role in the development of the next generation.

The best way to change this downward trend is to re-ignite the flame of entrepreneurship by helping each successive generation with developing meaningful capabilities (intellectual capital), careers, entrepreneurial characteristics and passions to build their own businesses and wealth. Entrepreneurship can play a key role in the development of the next generation. Families owning businesses typically recognize the need to instill the entrepreneurial mindset. Family banks can be more patient and flexible investors with family entrepreneurs, encouraging family members to take some calculated risks, while also having a few advisors educate, mentor and support them.

By providing a dedicated, family-friendly funding vehicle that's aligned with family core values, a family bank can assist the next generations with growing their own confidence, intellectual and financial wealth, while passing along meaningful values and building a strong entrepreneurship legacy.

Accountability

Encouraging the next generation to actually experience a sense of accountability, perseverance, responsibil-

ity and self-reliance is also key to building human and financial capital in wealthy families. This can start by having a working-age family member submit a basic written proposal to the family bank for a small loan to pay for equipment, clothing, supplies and marketing for a part-time summer business, like a house or boat painting company.

Each proposed project should show a financial plan with the ability to repay the borrowed funds and a produce a profit for the family bank (interest and/or gains from funding), as well as what the borrower expects to learn and gain personally from the family bank funding. This way, the proposal can be evaluated in terms of both

Family Governance & Family Banks

The best of both

Family governance remains the key to keeping family wealth, family businesses and families themselves close and harmonious from generation to generation. The term "family governance" refers to the simple idea that all families have a way that they make decisions together. This is governance.

Some decision-making patterns are more successful than others. For example, in a family ruled by a strong patriarch, the children often aren't included in the decision-making process. Just as with countries, over time the children will revolt. On the other hand, if a family is proactive in creating a governance system that's transparent, accountable and participatory, the family is far more likely to bond together with mutual respect and support.

Let's look at ways in which a family bank can add to the positive strength of a family governance system. I'll focus on the three key characteristics of great family governance: transparency, accountability and participation.

Transparency

As Warner Babcock mentions in this article, one of the key advantages of creating a professional family bank structure is the ability to have transparent transfers of family money: loans out and repayments in. No hidden gifts. Many family disputes arise from suspicions that some family members are getting more favorable (that is, unequal) distributions than others receive.

Of course, children have different needs among themselves, and those can also change over time. Parents are also inclined to take care of the needs of their children. Whether to call unequal distributions gifts or loans is a classic bind.

With a family bank, the child would make a request from the lending committee of the family bank. The committee (acting with the authority of the larger family group) would examine the reason for the loan, whether there's a repayment schedule and, just as a public bank would do, whether there are additional personal resources.

The big difference offered by a well-run family bank is that there would be transparency for all family members. The loans and their terms would be included in quarterly reports to the larger family (either directly, as in a shareholders' report, or indirectly, through the elected board of the family bank).

On a "best practices" global level for all businesses, transparency is a recognized hallmark of a well-governed business. A well-governed family can profit in the same way from practicing transparency—sharing information, especially about intra-family money transfers, among all family members. No secrets, just clear and correct information and open communication.

Accountability

Children with differing money needs and with unequal requests can benefit from family banks, but they need to be accountable. Unlike a side distribution (gift? loan?) from a family member or even from a family trust, with a family bank distribution, the child must account for the use of the money and be held to any repayment schedule that was a condition of distribution.

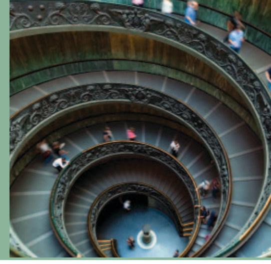
When the other children can see not only that the distribution was made, but also that there were certain conditions attached to the distribution, the recipient becomes accountable to the family bank (and thus to the larger family) and needs to demonstrate compliance, or explain why the conditions weren't met.

Senior family members may step into a mentoring role as part the oversight of the use of the family bank funds. For example, if the distribution were made for the purpose of supporting a new entrepreneurial venture, periodic status reports would be required. The recipient's aunts or uncles might choose to give advice and to mentor these efforts.

Finally, the addition of some independent directors to the family bank board would greatly strengthen the accountability related to the family bank transactions. As with all family businesses, it's tempting to allow personal family relations to override sound business decisions. For example, a personal private request for a distribution, made only to one senior family member, would instead need to be transparent, and thus accountable, to the board. This isn't to say that personal family relations aren't taken into account: this is, after all, a family. What's different is that the transparency and accountability will reassure the other family members that they all understand what's happening.

Participation

My opinion is that of the three critical characteristics, by far the most important one is participation. This is where so much estate planning fails. Too often, the only client is the patriarch (or matriarch) who has created the wealth and who's convinced (for many reasons, some of which are quite complex) that only he has



financial and human expected gains.

This formalized (professionalized) process of requiring a well thought out proposal for review by an independent and objective committee or board, as well as requiring the submission of a monthly update and final report with an analysis at the time of repayment can go a long way in helping develop financial skills and management capabilites. Having family members invest in the bank and/or alongside their project being funded, as "skin in the game," can also help motivate members. If the borrower struggles to repay or can't repay the loan, that is itself a valuable learning experience, which should be shared in the report. Not everyone can become an entrepreneur and not all entrepreneurial endeavors succeed.

A family should decide whether the family bank should emphasize financial or human capital development and results, or balance both, and communicate these expectations clearly. These can include building financial literacy, responsibility and acumen, as well as life and career skills. Furthermore, the experience should help develop management skills, joint decision-making, problem solving and the ability to work with others outside the family.

Working Together

The family should openly work together to create the family bank, allowing anyone to contribute or participate in its construction. The family should encourage all members to contribute some capital to the family bank, but this contribution should be voluntary. The more democratic and transparent the process, the greater the participation will be, and the family relationships will be healthier and stronger. Building family relationships should be a constant, on-going objective with family banks. Families should develop effective family-friendly governance policies to achieve harmony, to continually build relationships and create a sustainable family bank and a healthy family system for the benefit of future generations.

Although family banks could be structured and chartered to maximize a return on investment, minimize taxes, transfer the maximum amount of wealth or exert tight controls over the next generation, family banks should ultimately attempt to inspire and assist the next generation to develop human, intellectual and financial capital, while building meaningful, long-term family relationships using next generation oriented governance systems.

the wisdom and the right to make decisions for the future of the family. The old proverb is adopted: "e who has the gold makes the rules."

The fatal flaw in this approach is that the children don't participate in the planning for their own futures. No one likes being told how to live. Again, just as with countries, there will be a revolt.

On the other hand, if all family members are welcomed to participate in the creation and ongoing operation of the family bank, there are no seeds of revolt. Instead, there's a creative business opportunity with the possibility of involvement by all family members. To paraphrase an American slogan from the 1960s: "The family that runs a bank together, stays together."

One of Babcock's innovative ideas is that every family member should be encouraged to contribute some of their own funds (no matter how small) to the capital of the family bank. In this sense, I predict that each family member would feel that she's not only a participant, but also an owner.

In global studies of happiness, there's an organization (the World Database of Happiness) that ranks countries according to how "happy" their citizens report themselves to be. Not surprisingly, the top rankings don't come from more and more income (to wit: the adage that "Money can't buy happiness"), but from people who feel they have choices (freedom?) and can participate in their governments (the lack of which sparked the revolt in Egypt).

On a family level, the value of personal participation is at least as important. If every family member participates in the family bank, to different degrees and in different roles, everyone will have the sense of participation that's so important to keeping any group together.

Core Value

If it's set up well and operated in accordance with the three key principles of good family governance, the family bank can provide many opportunities for the family to participate together, share financial information and watch over and support each other. At the end of the day, isn't this the core value a family group has to offer?

— Barbara R. Hauser