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THE INTERNATIONALISATION OF CHINESE WEALTH – DIVERSIFY, PROTECT & GROW

2016

FOREWORD & OBJECTIVES

Increasingly, Chinese high net worth (HNW) and ultra high net worth (UHNW) clients are looking for new wealth management options, especially cross-border solutions, to diversify, protect and grow their wealth in today's complex world.

They are increasingly aware of the various challenges they face in relation to business succession planning and the transfer of their personal wealth to the next generation. This has brought with it a growing demand in terms of diversification of product, channel and destination.

Indeed, the 2015 version of the China Merchants Bank-Bain & Company China Private Wealth Report identified wealth preservation as the top wealth management objective, followed by wealth inheritance, which surged from the fifth priority in 2013 to the second last year, particularly among the UHNW.

The report also identified the new meaning of 'wealth inheritance' as part of the Mainland market's evolution. Increasingly, China's wealthy value a legacy of both material as well as spiritual wealth; they expect good virtues and capabilities, such as education, hard work and business philosophy, as part of their legacy.

These trends present significant opportunities for wealth managers and professional services firms targeting this growing segment.

This was the backdrop for proprietary research conducted by Hubbis and Jersey Finance in September 2016, via an online survey, one-on-one interviews and a roundtable discussion. The objectives were to highlight key trends and topics linked to the demand for advice and solutions, amid the flow of assets and people from the Mainland, and to help provide answers to questions such as:

- What are drivers and also risks for Chinese HNW and UHNW clients in trying to diversify, protect and grow their wealth?
- What is the impact of transparency and tax initiatives on appetite for solutions and advice among Chinese clients?
- How will assets transfer across generations?
- What advice do Chinese families need in today's complex world?

This research has been produced in conjunction with Jersey Finance. Jersey has, over the past 50 years, developed into a high-quality international finance centre (IFC) that understands the needs and requirements of Chinese investors.

We greatly appreciate the time and contribution of the participants in contributing to these insights.

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EXECUTIVE SUMMARY

"The two most significant hurdles holding Chinese clients back when it comes to wealth transition are: where to even start the discussion; and what is seen as a lack of good advice or options."

There appear to be two primary needs for China's HNW and UHNW populations. The first is to diversify and protect their wealth in an increasingly-complex world; the second is to have proper succession planning for family businesses and personal wealth.

Indeed, according to our survey of 45-plus industry practitioners across Hong Kong and Singapore who service these individuals, business succession planning is their main focus today (43%). This is followed by a mix of insurance / protection, estate planning, and legacy planning – which are roughly equally weighted.

The challenges in meeting these requirements, however, are highlighted by the general lack of diversification of assets, along with a limited knowledge of managing risks and available solutions.

Further, specific issues that some of these individuals might face include: the depreciation of the RMB against the US dollar; investment in unfamiliar markets (overseas real estate and financial products); and understanding the implications of inheritance taxes in mature markets.

Of increasing concern and uncertainty to many of these individuals are the expected developments in relation to estate and inheritance taxes, along with the global drive towards tax transparency.

Perhaps most notably, however, the two most significant hurdles holding Chinese clients back when it comes to wealth transition are: where to even start the discussion; and what is seen as a lack of good advice or options. Combined, these difficulties account for roughly 80%, based on survey respondents.

A growing role for service providers

As the China market continues to open and the wealthy become more sophisticated, HNW and UHNW clients are increasingly looking to diversify their holdings outside of the Mainland.

These individuals also see overseas investments as a way to achieve more diversified (and potentially higher) returns through access to a broader selection of products and services than is available domestically, due to recent stock market performance in China.

In line with this, wealthy individuals and families are turning to wealth management specialists, both foreign and onshore, to help them achieve their objectives. It is therefore becoming necessary for these individuals to access a full suite of wealth management services – including estate and wealth planning, and real estate.

While China's HNW and UHNW prefer to take a predominantly active role in their own investments and looking after their assets, there are signs that more of them are entrusting a larger share to professionals.

Perhaps most exciting for wealth managers and other advisers over the long-term, meanwhile, is the fact that the recent volatile environment has heightened awareness and demand among HNW and UHNW Chinese for financial planning and wealth structuring expertise.

At the same time, wealth managers need to be aware of what matters to these clients in terms of what they are looking for from their fiduciary providers.

According to respondents to the online survey, the three most important elements (roughly equally weighted) are: offering tailored approaches; delivering a high degree of personalisation; and creating confidence for the clients that they feel in safe hands.

"HNW and UHNW clients are increasingly looking to diversify their holdings outside of the Mainland."

"The biggest misconception Chinese families have with wealth structuring is a 'loss of control' (72%)."

More structuring needed

Ultimately, there are various drivers behind Chinese clients increasingly looking to engage wealth structuring options and solutions, often linked to their various concerns about how to protect their wealth and legacy amid the existing framework.

But while most wealthy individuals in China understand the use of a will, the understanding and utilisation of other planning ideas such as pre-nuptial agreements, trusts and foundations are still in a relatively developmental stage.

This might be explained by the fact, according to the survey's respondents, that the biggest misconception Chinese families have with wealth structuring is a 'loss of control' (72%).

Another issue for these clients to contend with is family business succession. For instance, practitioners are seeing a growing number of situations where children within wealthy families, especially if they have been abroad to study, are not keen to take on responsibilities of family businesses.

In some cases, family governance can help. Anecdotally, according to several professional services advisers during the research process, they say that the creation of family charters and setting up family councils has been well-received by Chinese clients.

Philanthropy is also a concept which is gaining some traction among families, although domestic laws are not well developed yet in this respect.

When it comes to trusts, most of the planning done to date has been based on foreign models where overseas-based trusts own overseas assets. Domestic PRC trusts are not being used in any material way for such planning yet and clients still face difficulties transferring onshore assets into overseas-based trusts.

Asset planning, family succession and the diversification of wealth are often the key drivers for much of the cross-border structuring out of China. A smaller proportion of it, some practitioners say around 25%, is done for tax purposes.

As more Chinese wealth moves across borders in search of protection and other wealth solutions, (subject to currency controls) growth in the overseas-based trust market is expected, at least in the near term. This is pending the anticipated amendment of the individual income tax laws and possible introduction of gift/inheritance tax.

RESEARCH SCOPE & CONTEXT

Recognising some of these developments and trends underway in the Mainland, the research involved the views of over 50 practitioners working in this market. These included individuals at private banks, trust and fiduciary services providers, tax consultants, law firms and other professional services firms – who participated in at least one element of the research. The goal was to get their perspectives on some of the following themes:

Family policy
- The change in demographics over time
- Impacts and considerations for children studying overseas – the UK as a place to study, property, moving money across borders, demand for ‘offshore’ banking / wealth management

Transfer of wealth to the next generation
- Potential risks for Chinese HNW clients (such as upcoming estate taxes, inheritance taxes, changes in payment methods)
- Challenges in business succession planning and also personal wealth transfer
- Potential structures and solutions
- Reputational risk – how important is this to clients (and what do they look for) when choosing a jurisdiction (in the wake of the spotlight on jurisdictions like BVI and Cayman following the Panama Papers incident)

Family offices
- What this term means to Chinese clients
- Key trends and demands for this type of service
- Types of family business, growing trends for internationalisation
- Cross-border considerations, including tax transparency – and the need to work with long-term planners

The one-on-one discussions were complemented by further research in two ways:

- An online survey of 47 professional services practitioners in Hong Kong and Singapore, along with wealth structuring specialists working at private banks and multi-family offices. Results were gathered on an anonymous basis
- A thought-leadership roundtable in Hong Kong to discuss the key talking points in relation to this trend

KEY FINDINGS

1. Being educated and prepared

There are various ways that the wealth management industry can help further develop and support the trend of the internationalising of Chinese wealth.

For many UHNW clients from China, for instance, they need to be educated on how wealth should be managed overseas, properly and professionally, with optimal results.

This also includes managing their expectations when it comes to accepting less aggressive returns relative to the yields they may otherwise receive from the domestic China market.

More specifically when it comes to estate and succession planning, pre-empting any issues is crucial when advising Chinese clients.

Respondents to the survey pinpointed the use of 'wrong or unnecessary structures' as the most likely aspect of the process to create problems for clients (45%). This is closely followed by a mix of 'wrong advice about what clients need' (24%) and 'family disputes' (24%).

Such friction is inevitable, so more time and attention needs to be spent than many clients think on how they pass on their wealth without destroying the family unit.

"The use of 'wrong or unnecessary structures' as the most likely aspect of the process to create problems for clients (45%)."

Probably the one common factor in every family dispute which needs to be addressed is transparency, to ensure everyone knows what is going on. This requires advisers to work with patriarchs to explain to the next generation as early as possible the dynamics of the family wealth and status. They are then in a position to start to be educated about what is involved with inheriting, managing and investing that wealth.

A yearly or twice yearly family 'retreat', for example, is one way that some practitioners work with their clients, to get everyone in one place and focused on ways to minimise disputes via communication and developing a shared vision.

Along these lines, 62% of the respondents to the survey highlighted 'defining the family DNA' as being the best place to start when creating a family constitution.

This is seen as a far better jumping-off point compared with other options such as 'setting up a family board'. 'creating a dispute resolution mechanism', and 'assessing the financial, emotional and social capital'.

Further, and more broadly, many clients from China are not fully aware of the implications of FATCA and the Common Reporting Standard (CRS). However, some of them already feel the inconvenience of dealing with banks where their foreign nationalities might have an impact – such as in cases where they have become US citizens or a permanent resident.

This has often led to surprise that their assets overseas will be exposed to the government authorities in China or adopted new countries.

Many practitioners agree that the most pressing issue going forward is going to be CRS, other exchange of information initiatives and money laundering issues.

Worries over the implications of CRS, for example, include the impact on existing structures which might not necessarily be compliant any longer as tax and reporting laws inevitably change.

Clients therefore need more advice on how to properly structure wealth holdings in an increasingly transparent and compliance-driven world.

Yet at the same time, advisers, too, need to be cautious about exposing themselves to offences or charges under relevant CRS or other regimes by taking too proactive a role in structuring advice.

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2. Structuring solutions

There are a variety of structures and solutions which have potential to gain ground in helping wealthy Chinese achieve their objectives.

Trusts of various types inevitably can play a key role in locking in capital, and either giving different parties rights to income, or restricting them.

One of the biggest challenges in China, however, remains the fact that for Chinese clients, while they like the idea of setting up trusts, many don't really understand that this involves the transfer of control to their trustees.

For example, clients know there are often question-marks over the interest of the next generation in running the family business. As a result, trusts can be part of a packaged solution to deal with this.

Further, Chinese clients increasingly say they want to leave the majority of their estate to charity, or for philanthropic purposes.

In line with this, as well as other initiatives such as family governance, family offices have emerged from an almost non-existent status a few years ago to become a popular choice especially among the UHNW population.

This is in line with the views of the respondents to the survey. Family office structures (38%) are the most popular among Chinese families today, followed by traditional trusts (29%) and Private Trust Companies (22%) as the next two.

Looking ahead five years, respondents predicted this trend will be exacerbated, with just over half of Chinese families opting for family office structures.

By that time, family constitutions and foundations will have become a little more popular too (with a similar result for traditional trusts).

This is evidence of a growing understanding of the potential for other products.

Foundations, for instance, are flexible vehicles that can be created for charitable or non-charitable purposes, or a mixture of both.

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They offer infinite duration and capacity, plus they allow transparent registration with the regulator, the flexible composition of a council of members and further safeguards through an appointed guardian, which ensures the council of members pursue the foundation's stated aims.

The Jersey Foundation, in particular, is not a carbon copy of similar vehicles available elsewhere. It embraces additional regulatory oversight, an important consideration for those planning to transfer existing foundations from another jurisdiction to Jersey.

As well as featuring certain attractions of a trust vehicle, foundations have some of the benefits of a company structure, including separate legal status, which enhances their appeal to private clients and their advisers, especially in civil law jurisdictions.

Jersey's foundations law was introduced in 2009. Since then, Jersey foundations have become increasingly popular; 320 of them have been formed since 2009.

Migration and citizenship programmes have also proved a popular option for many wealthy Chinese from the Mainland.

Their desire to obtain an alternative or second citizenship, via the growing number of Citizenship-by-Investment Programs (CIPs) and other schemes available to them and their families, has steadily increased over the last few years, and is expected to continue to do so.

Personal security, tax planning and mobility are among the reasons why wealthy Chinese people apply.

In particular, a primary motive behind obtaining a second passport for Mainland Chinese has been driven the limited 'travel-ability' of their passports. The fact that a PRC passport allows visa-free access to just 50 countries around the world has made wealthy Chinese among the most highly-motivated to achieve greater mobility.

However, these options have frequently proven themselves to have unintended consequences.

For example, sending children to college in the US might have seemed a good idea, but becoming subject to US tax on worldwide income has been a strong wake-up call for many Chinese clients, in addition to their existing tax obligations.

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There is also some discussion around insurance, pensions and other sophisticated planning tools as having some potential to become more important over time.

To be well-positioned in this way, insurers can do several things to capture and be successful in the Chinese market.

These include: getting an onshore license; keeping up with the pace of digital innovation and online sales; being creative when it comes to social media promotions, such as on WeChat; selling through banks and their brokers, and looking at new and alternative distribution channels, for example real estate buyers or soccer club members.

3. Tax-related risks

One of the biggest issues the wealth management industry is likely to be dealing with over the next couple of years stems from the changing tax laws in China.

With the expected arrival at some point soon of the individual income tax law, a review will need to be made of the overseas-based structuring that clients in China have done to date.

A big question among many advisers is whether this will impact the international trust structuring and corporate structuring that Chinese clients have used in the past, and might wish to do in the future.

For example, will existing overseas structures be grandfathered? If not, maybe they will no longer be tax-effective?

One thing is certain: clients will need to review all structures set up outside China.

A related issue is the Chinese tax consequences where a patriarch effectively controls from within China an overseas-based trust or company, thus making them subject to PRC tax on their worldwide income.

Further, CRS means that governments from 100 countries should be reporting to the Chinese tax authorities the details about most of the bank and other accounts that Chinese residents have in those countries.

Many practitioners predict this will lead to a new era of tax audits and investigations, requiring compliance with the law.

Voluntary disclosure, or emigration, seem to be the main options, according to the views of some practitioners.

As a result, for advisers with Mainland China-based clients, it is time to look at their tax affairs to ensure they will remain compliant going forward.

Based on the views of respondents to the survey, meanwhile, 'confidentiality' is the most acute tax / transparency-related concern among two-thirds of Chinese clients.

Other worries range from 'security' to a 'lack of trust with their own tax authorities' to 'political exploitation', although the survey results didn't suggest any of these are significant concerns relative to confidentiality.

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4. The gateway

Depending on who you talk to will lead to different answers to the question of where the gateway of the future will be in offering the best access to China's wealth.

Broadly, professional services firms sense a swing among wealthy Chinese individuals from so-called 'offshore' to mid-shore jurisdictions, such as Singapore and Hong Kong.

According to some reports, China's HNW growth has resulted in a 47% increase in the amount of money flowing into Hong Kong between 2012 and 2014. Similarly, Singapore saw a 32% increase.

Within Asia, for the time being, it seems, Hong Kong is certain to continue to be a key centre. Yet Singapore also has an increasingly role, given that it has become an important, well-regulated and reputable wealth hub internationally.

Though seemingly not as convenient a base as Hong Kong, Singapore remains an attractive market for Chinese investors.

Yet there is still clearly appetite for more traditional IFCs which have captured the attention of Chinese clients.

And in addition to some of the most trodden routes to date, there are signs of greater interest in jurisdictions like Jersey.

For example, US-listed Chinese wealth manager Noah Holdings obtained a license in mid-2016 to offer Jersey trust structuring to its 115,000 wealthy Mainland clients.

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In doing so, Noah became the first Chinese wealth management company with a license from Jersey (and one of the first firms to obtain one from any IFC) to carry out such business.

The move also further reflects increased Chinese demand to allocate assets overseas and diversify risks.