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NATIONAL FISH AND WILDLIFE FOUNDATION

Session 12: Long-Term Management & Financing

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NFWF'S Involvement with LTMM Funds

- Or, who are we and why are we here?
  - NFWF Impact-Directed Environmental Accounts (IDEA)
  - Administers funds designated for the benefit of specified natural resources from *enforcement and regulatory* proceedings
  - Enforcement funds - settlement of judicial/administrative cases
  - Regulatory funds - permit-derived mitigation funds

- Mitigation funds managed by IDEA
  - Short-term measure mitigation funds (restoration, enhancement, acquisition, etc.)
  - Serve as Sponsor of ILF wetlands mitigation program in the USACE Sacramento District
  - Holder of long-term measure mitigation funds (LTMM and "mitigation endowments")

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Today's Objective

- Provide an understanding of principles applicable to the establishment and administration of long-term management and monitoring funds ("LTMM Funds") for mitigation sites
  - Principles apply equally to mitigation bank sites, ILF project sites, and permittee-responsible project sites
  - Addressed in the 2008 Rule by 33 C.F.R. §332.7(d)(2) and (3)
  - §332.7(d)(2) requires a long-term management plan addressing:
    - the long-term management needs of the site;
    - annual cost estimates for those needs; and
    - the funding mechanism to pay those costs
  - §332.7(d)(3) provides a list of appropriate long-term funding mechanisms

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Key Issues for LTMM Funds

1. Nature of LTMM Funds -- difference from "Financial Assurances"

2. Importance of up-front planning and modeling

3. Options for legal structure of funding mechanism

4. How to size the initial amount of the fund

5. Ongoing operational rules of the fund

The Nature of LTMM Funds

- Long-term or “perpetual” in duration
  - Expected to pay the costs of long-term management and monitoring of the mitigation property for a very long time
- Contrast with Financial Assurances
  - 33 C.F.R. 332.3(n) establishes requirements for financial assurances to ensure project completion
  - Acceptable mechanisms are “performance bonds, escrow accounts, casualty insurance, letters of credit,” etc.
  - These mechanisms are phased out once the DE determines the project has met its performance standards
- FA is *near-term*; LTMM is long-term/perpetual
- FA is *contingent*; LTMM is expected to be drawn over time

Planning for the Long-Term

- Keep in mind: the LTMM Fund will be expected to "perform" for an indefinite period of time
- Options for returning to the payor for additional funds are likely limited as a practical and legal matter
  - Risk of insolvency, bankruptcy, dissolution, etc.
- The inputs and assumptions adopted up-front will directly affect the fund's likelihood of success
- Consider the use of planning tools:
  - TNC's long-term stewardship calculator (2016)
  - ELI – LTA Handbook on long-term stewardship (2012)
  - Stewardship planning & costing software
- Bottom line: it's worth investing time at the outset because perpetuity is a long time to be wrong

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Legal Structures for the LTMM Fund

- Under§332.7(d)(3), appropriate funding mechanisms for long-term stewardship costs include:
  - "Non-wasting endowments"
  - Trusts
  - Contractual arrangements with future responsible parties; and
  - Other appropriate financial instruments
- Key goals of all of these mechanisms should be:
  - Ensure the funds are legally restricted to the purposes and property for which they were extracted, consistent with applicable law, regulation, and permitting documents
  - Ensure the mechanism is based on legal, financial, and operational principles that provide the mechanism with a strong statistical chance of persisting indefinitely

A Note on "Non-Wasting Endowments"

- "Non-wasting" terminology is not used in modern endowment management practice
- Arose from now-obsolete laws that had applied "principal and income" or "historic dollar value" approaches to endowment investment and spending
- Modern endowment law, codified in the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), has abandoned P&I and HDV approaches
- UPMIFA incorporates a general standard of prudent spending measured against the purpose of the fund, and invites consideration of other factors
- UPMIFA was *designed* to allow spending from "underwater" funds

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Implications of Different Legal Structures

- Whatever structure is approved for the LTMM Fund should be memorialized in appropriate documentation
- IRT permitting agencies should consider the extent of their ongoing oversight rights to ensure the funds are being managed and spent appropriately
- Beyond the four corners of the legal structure document, other authorities may apply to the fund:
  - The law pursuant to which the funds were extracted (i.e., CWA)
  - Accompanying regulations, policies, and guidance
  - The terms of the permit(s) that required the funds
  - And otherwise, “background” law, e.g., contract law, trust law, fiduciary law, etc.
- Remember: the legal and accounting treatment of the funds matters

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Sizing the Initial Amount of the LTMM Fund: First Steps

- A critical issue is how to determine the fund's initial amount
- This can be separated into at least four separate steps:
  - Creating the long-term management plan
  - Itemizing that plan into specific annual tasks
  - Assigning a cost to each itemized task
  - Translating that cost stream into an up-front funding need
- The first 3 steps are often accomplished through different types of "property analyses"
- Accuracy in the first 3 steps is critical to the accuracy of the up-front funding calculation

Sizing the Initial Amount of the LTMM Fund: The Role of the Cap Rate

- After the LTMM plan has been developed and costed, the next step is to convert the year-over-year cash stream need into the up-front funding amount
- This is accomplished through the application of what is known as the capitalization rate, or “Cap Rate”
- The Cap Rate is the percentage of the LTMM Fund necessary to be drawn each year for LTMM costs
  - Cap Rate x Initial Amount of LTMM Fund = Annual Cash Need
- To solve for the LTMM Fund amount, the formula is:
  - Annual Cash Need ÷ Cap Rate = Initial Amount
  - Example: $20,000 ÷ 0.03 = $666,667

Sizing the Initial Amount of the LTMM Fund: Selecting a Cap Rate

- The Cap Rate reflects the net amount of gain (%) that the portfolio must realize each year on average to meet the cash requirement for LTMM costs
- "Net" in this sense is not only net of fees (investment manager and other administrative), but also net of inflation
- Assuming administrative fees at 1% and inflation at 3% annually, the fund must be projected to return on average 4% annually before introduction of *any* Cap Rate

Sizing the Initial Amount of the LTMM Fund: Relationship of Cap Rate to Return Target

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Inflation	3%	3%	3%	3%
Admin Fees	1%	1%	1%	1%
Cap Rate	5%	3%	1%	0.5%
Target Rate of Return (Nominal)	**9%**	**7%**	**5%**	**4.5%**

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Sizing the Initial Amount of the LTMM Fund: Who Selects the Cap Rate?

- Bank sponsors, ILF sponsors, or permittees *propose*
- IRTs *approve*, either explicitly or implicitly
- IRTs (and other permitting agencies) generally attempt to balance two primary competing factors:
  - On one hand, requiring a lower Cap Rate increases the statistical likelihood of successful funding in perpetuity
  - On the other hand, allowing the use of a higher Cap Rate decreases the amount that must be paid up front, and thus is often advocated by payors (i.e., bankers, sponsors, permittees)
- These competing factors reflect the risk-reward calculus inherent in determining the Cap Rate and the initial amount of the fund

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Sizing the Initial Amount of the LTMM Fund: Effect of Different Cap Rates

The <u>lower</u> the Cap Rate, the <u>higher</u> the initial amount of the fund:

Annual Cash Need	Cap Rate	Initial Fund Amount
$20,000	5%	$400,000
$20,000	3%	$666,667
$20,000	1%	$2,000,000
$20,000	0.5%	$4,000,000

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Sizing the Initial Amount of the LTMM Fund: Cap Rate Must Relate Rationally to Investment Strategy

- Whatever Cap Rate is proposed, it must bear a coherent relationship to the investment strategy for the LTMM Fund
- Lower Cap Rates *may* allow for less risky investment portfolios
- Cap Rates in the range of 3-4% would require investment strategies expected to return, on average, 7-8% annually
- Achieving 7-8% annually requires a diversified asset allocation within the investment portfolio
- Any portfolio should be defined by a written Investment Policy Statement that accurately reflects the return target inherent in the Cap Rate

Operational Rules for a LTMM Fund

- Presumption that the annual amount needed for LTMM work per the plan *will be disbursed* each year to fund the necessary work
  - Often funded in an annual, advance lump sum
  - Any overage at year end can be offset against next year payment
- In this sense LTMM Funds can be conceived as more analogous to defined-benefit plans (e.g., pensions) than true endowments
- Agencies may also require various “buffering mechanisms” or fail-safes in conjunction with this approach

Common Buffering Mechanisms

- Require several years' worth of initial annual funding to allow the LTMM Fund to mature ("delayed spend")
- Require in the cash need analysis (1) a minimum contingency amount and/or (2) funds for adaptive management
- Do not allow incremental disbursement of funds for non-annual work items (i.e., for periodic fencing, allow only the full draw for the year needed)
- Retain ability to suspend or reduce disbursements to protect viability of the LTMM Fund
  - Develop early consultation process with affected land managers to examine impact of reduced or suspended draws from the LTMM Fund

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Some Key Questions for IRT Agencies

- Who is responsible for determining what LTMM activities are required on the property over time?
- How will line-item costs be developed for those activities?
- What is the agencies' risk tolerance for investment of funds, and thus the "target return" that drives a Cap Rate?
- What are the inflation and administrative fee assumptions?
- Does the investment strategy match the return target?
- What are the general rules around annual disbursement of funds to long-term property managers?
- What level of oversight does the IRT want regarding monitoring of LTMM work, the LTMM Fund, the long-term property manager, and the Fund holder?

Parting Thoughts

- Since LTMM Funds are expected to exist perpetually into the future, there is no certainty in the analysis, only statistical probabilities
- The best that can be done is sound modeling
- Endowment-style investment portfolios entail diversified asset allocations
- Diversified asset allocations entail risk:
  risk can be managed but not eliminated
- "Past performance is no guarantee of future results"

Questions?

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