TOPIC: Revision to Board of Regents Policy VIII-5.30 - Policy on Endowment Fund Spending Rule

COMMITTEE: Finance

DATE OF COMMITTEE MEETING: November 15, 2012

SUMMARY: By State law, the University System of Maryland is required to manage endowed gifts and funds in a manner that balances the need for continuity and predictability of spending for donor purposes, against the investment approach and goals in a balanced fashion that ensures the long-term objectives associated with the gift continue to be satisfied on an ongoing basis. This means that annual spending from endowment funds needs to fit within long-term expectations of investment returns.

Since 2005, investment of the Common Trust Fund, the System's aggregation of more than 400 endowed funds, has been managed by the University System of Maryland Foundation. For the past year or so, the Investment Committee of the USM Foundation has been suggesting that governing boards adjust downward long-held expectations of future investment returns in reconsidering spending policies. The attached policy reflects that reconsideration of annual spending from endowment funds, and reduces overall spending to better reflect current expectations of future investment returns.

There are two components of spending from USM Common Trust Fund accounts that are the subject of the Endowment Fund Spending Rule: (1) donor-specified spending objectives, and (2) a reimbursement to institutions for administrative costs they incur in satisfying the donor-specified spending objectives (selection committee costs, accounts payable and administrative overhead are some examples of costs that may be reimbursed).

The amended policy reduces the target spending rate from the current 4.75% to 4.25%, and reduces the administrative cost reimbursement rate from the current 0.95% to 0.5%. To enable a smooth transition for the institutions and departments relying on these funding streams and enable institutions the opportunity to build replacement funding in the operating budget, both provisions are to be phased in over a 4-5 year period, beginning with fiscal year 2014.

ALTERNATIVE(S): The Board could elect to leave the current policy in place.

FISCAL IMPACT: These adjustments should have a positive impact on the health of the fund.

CHANCELLOR'S RECOMMENDATION: That the Finance Committee recommend that the Board of Regents approve the revision to the Board of Regents Policy VIII-5.30 - Policy on Endowment Fund Spending Rule as proposed.

COMMITTEE RECOMMENDATION: DATE:

BOARD ACTION: DATE:

SUBMITTED BY: Joseph F. Vivona (301) 445-1923

VIII-5.30 - POLICY ON ENDOWMENT FUND SPENDING RULE
(Approved by the Board of Regents, June 21, 1990; Amended by the Board of Regents, April 12, 1996, Amended by the Board of Regents, June 27, 2003. Amended by the Board of Regents,)

General

Expenditures from the University System of Maryland Endowment Fund shall not generally be made for ordinary operating expenses. The Endowment Fund shall be used, instead, for designated purposes, such as scholarships, special grants, and research projects. Since costs of these activities can be expected to be affected by increases in the cost of living, the following guidelines are established:

1. The Endowment Fund spending policy is framed with a view to preserve purchasing power of the fund assets over time; to protect against erosion of nominal principal; and to promote stability and predictability of annual budgeting.

2. In calculating the distributions as detailed below, a general constraint or limitation will be that distributions will be made only to the extent that the individual gift or fund will not be reduced below its original value.

3. The implementation of the Endowment Fund spending policy will span two phases: a transitional phase comprising fiscal years 2014 through 2018, and a permanent phase beginning in fiscal year 2018 and extending into the indefinite future.

The procedures for determining the annual per share (or unit) distributions in each phase are as follows:

TRANSITION PHASE (FY 2014 through 2018)

a) The target long-term spending rate is 4.65%, a target rate that is to be reduced by .10% each year until it reaches a target rate of 4.25% for FY 2018, applied to the endowment market value basis. The endowment market value basis is the simple average of the per share market values of the 12 quarters running through the fiscal year immediately preceding the year of distribution.

b) Each year, the per share distribution is the prior year's distribution increased by an inflation rate of 2%, subject to the following limitations:

   I. If this calculation, upon substantial decline in the market value, produces a per share distribution exceeding 5.0% in fiscal year 2014, a ceiling which is to reduced by .10% each year until it reaches a level of 4.5% of the endowment market value basis, the current per share distribution is the lesser of the ceiling rate applied against the market value basis or the previous Year's amount.

II. If this calculation, upon substantial increase in the market value, produces a per share distribution less than a floor or minimum of 4.50% in fiscal year 2014, and reduced by .10% each year until it reaches a level of 4.0% % of the endowment market value basis, the current per share distribution is to be that fiscal year’s floor or minimum rate of the market value basis.

c) The per share distribution determined under subsection b)above, shall be increased to reimburse institutions for the costs, including indirect costs, of administering endowments at the representative institutions and the System Office. The reimbursement of costs of administering endowments will be limited to 0.90% of the market value basis in fiscal year 2014, and in each successive year, by reduced by .10% until the reimbursement rate is 0.50% of market value basis in fiscal year 2018.

An additional distribution shall be made to reimburse the System Office costs, including indirect costs, of administering the Common Trust Fund, limited to the lesser of the previous year's distribution, increased by the inflation rate of 2%, or .15% of the market value basis.

PERMANENT PHASE (FY 2018 AND THEREAFTER)

d) The target long-term spending rate is 4.25% applied to the endowment market value basis. The endowment market value basis is the simple average of the per share market values of the 12 quarters running through the fiscal year immediately preceding the year of distribution.

e) Each year, the per share distribution is the prior year's distribution increased by the University's projected long-term inflation rate of 2%, subject to the following limitations:

III. If this calculation, upon substantial decline in the market value, produces a per share distribution exceeding 4.50% of the endowment market value basis, the current per share distribution is the lesser of 4.5% of the market value basis or the previous year's amount.

IV. If this calculation, upon substantial increase in the market value, produces a per share distribution less than 4.0% of the endowment market value basis, the current per share distribution is 4.0% of the market value basis.

f) The per share distribution determined under subsection d)above, shall be increased to reimburse institutions for the costs, including indirect costs, of administering endowments at the representative institutions and the System Office at a rate of 0.50% of market value basis.

An additional distribution shall be made to reimburse the System Office costs, including indirect costs, of administering the Common Trust Fund, limited to the lesser of the previous year's distribution, increased by the inflation rate of 2%, or .15% of the market value basis.

g) The distributions under subsections c) and f) above shall be reviewed annually by the Finance Committee to ensure consistency with the target spending rate and the spending objectives stipulated in section 1 above.

4. In the event of a protracted market decline leading to a loss of 20% or more of the portfolio in a one year period, the Finance Committee will cause this spending policy to be reviewed, giving consideration to actual reduction in the amount of annual distribution.

Replacement for: BOR V - 1.01