Trends in Establishing and Managing Trusts

Compiled by the Community Development Institute
at the
University of Northern British Columbia

January 2007

Trends in Establishing and Managing Trusts

Introduction

There are relatively few trusts active within British Columbia that serve the needs of a regional economic diversification and development mandate. Each of these trusts also has a unique history, context, and purpose – in fact, the degree to which each trust has taken on the character of the region (and its time of creation) is quite remarkable. As a result, comparisons across trusts can be made, but identification of trends in the evolution of trusts is more difficult. This brief summary seeks to identify helpful components in the establishment and management of trusts so as to inform governance groups interested in setting up a new trust. The observations offered reflect our interpretation of best practices based on available information, rather than a linear analysis of trends and future directions from those trends. We believe that the topics and issues identified will at least give any governance group a sufficiently broad base upon which to consider questions crucial in creating and managing a new trust.

Outline

This trends report is comprised of two sections. The first section makes comment upon 7 categories:

- Purpose
- Source of Funding
    - Investment Management
    - Financial Management Principles
- Governance
    - Type of Management Structure
    - Members
    - Accountability
- Organizational Structure
- Program Delivery
- Procedures for Funding
- Communication Mechanisms

The second section contains a ‘Pros and Cons Comparison’ of the Alaska Permanent Fund, the Alberta Heritage Savings Trust Fund, and the Gwaii Trust Fund. The comparison notes numbers of the items identified in the first section.

Section I

Purpose

Clarity of purpose has been shown as a critical starting point to all features of trust development.

- Among choices in 'purpose' is whether the trust will take a leadership and visioning function in guiding development of the region or whether it will simply be a reactive funding agency for local initiatives. The effectiveness of the Columbia Basin Trust suggests that taking a leadership and visioning function is fruitful.

Also important is the mechanism and flexibility for changing the purpose and the intent of a trust. While there is a need to remain flexible, there is a larger need to protect predatory changes which could degrade the long term benefits of trusts in favour of short term political or economic circumstance.

Payment of benefits to individuals looks to accrue fewer long term benefits than does investment in strategic priority areas. This is especially the case where the purpose focuses expressly on diversifying local economies and communities.

The most clear way to translate purpose into action is through the trust business plan. Once developed, such business plans must be the foundation for action. They must also contain a process for periodic revision.

Clarity of purpose, goals, and relationships to other levels of government and funding, can help to address one of the key challenge runs through the establishment of a trust. This challenge centres on the potential that a range of external and internal stakeholders may begin a knee-jerk reaction to the need for any service or infrastructure by responding 'let the trust pay for it'. Having a large endowment can create an attractive target for residents resisting tax increases or other levels of government seeking to off-load their responsibilities.

- In most cases, trust funding guidelines will speak to the issue of incrementality – that is, trust funding must be additional to that normally available from/provided by other levels of government through the regular exercise of their jurisdictional responsibility.
- Some also state that their funding support is not meant to replace that which is normally available from/provided by other channels.
- Despite such statements, not only can incrementality still seem to creep in, but comments suggest that having a trust fund means that the pressure to off-load all new initiatives to the trust can be great.

Source of Funding

Initial investments must be sizeable enough in order to generate revenues to support trust operations in early years. There is considerable difference across trusts in the size of the initial investment.

In addition to an initial investment, ongoing investments are also important. In many cases, these investments come direct from ongoing resource industry revenues. However, it seems prudent to have available the ability to generate income to grow the trust from different revenue streams (including real estate investments).

Investment Management

There is an increasing move to using dedicated financial investment managers and/or financial custodians to manage trust investments.

Contracts for investment managers need to include limited terms, performance indicators, and contract cancellation rules if performance does not meet expectations.

Government and private sector investment managers each seem to have been effective in the reviewed trusts. Within the reviewed trusts, private investment managers appear to generate higher levels of return even while operating within the constraints of the BC Trustee Act.

Investment oversight must include both internal and external audit functions. Internally, the trust establishes an audit committee, while externally, the trust appoints a respected firm to conduct an arms' length annual audit.

Increasingly, arms' length audit firms will also undertake audit reviews of governance and management functions.

Financial Management Principles

It is key that the investment income be protected as a long term endowment.

There is a need to inflation-proof in accordance with endowment management principles to ensure that the initial allocation (and subsequent investments) retains its purchasing power in the face of inflation.

Application of the 'prudent investor rule' should be in the trust mandate and should follow the foundations outlined in the BC Trustee Act.

Trusts seem effective in operating with multiple account management. At a minimum, one account has to cover the inflation-proofed principal, a second account needs to cover trust operations, and a third account needs to cover trust activities (such as programs and strategic investments). Some trusts operate with as many as 7-9 accounts.

If organized under the BC Trustee Act, assets in portfolios must be managed in accordance with the Act. Diversified portfolio investments are preferred.

Governance

The decision between a single tier (single board) and a two tier (board of directors plus regional/sectoral advisory committees) is dependent upon the regional size of the trust. Advisory committees are helpful in building public confidence in accountability where the board cannot represent all participating communities and areas. Advisory committees can also help to ensure that investment decisions are made in locally and regionally appropriate ways.

Keeping the trust at arms' length from government operations is important to ensure autonomy and integrity. This may be modified by a reporting mechanism which runs through a minister to government.

There is a need to separate the investment and spending functions within the management structure. Investment functions may include investments and auditing committees, while spending functions may include program or projects committees.

Type of Management Structure

Most trusts function with a board of directors.

Some function with regional/sectoral advisory committees (noted above).

Some function with advisory committees not connected with the governance structure per se, but these provide input with respect to priority and program development.

Most boards function on a voluntary basis, with remuneration for costs incurred.

Boards need the flexibility to create ad hoc committees as situations arise. Rules should permit ad hoc committees to include non board members with relevant expertise.

Decision-making structures typically involve simple majority votes with special cases (ie plus 75%) for constitutional/budgetary change issues. Most trusts use an operating principle of consensus development since investment decisions are to create broad regional benefits.

Board Memberhip

Board size most often is between 10 and 12 members.

Board membership is typically two or three years. It is considered good practice to stagger appointments so that board renewal is never more than 50%.

The method of selection is often dependent upon legislation. The most difficult situations appear in cases where all board members are appointed by senior government.

Appointment of board members is effective when the majority are locally appointed. A mix of local and provincial representatives can lend accountability at both levels. Involvement of senior government appointees can create a connection to public policy. Ultimately, directly selected regional voices assist accountability.

Where not tied to legislation, some trusts use existing structures (local municipal/band elected officials) for the appointment of board members. A transition strategy is to use existing electoral processes (municipal/regional district/band) and then move to an election process for the trust.

A particular challenge for regional trusts is representation of unincorporated territory. Local appointments, in this case, run the challenge of finding an election mechanism.

Accountability

All trusts must operate with transparency.

Annual financial audit statements are a necessity.

Annual reports are also a necessity.

A formal structure for public involvement and communication is also important for accountability and transparency.

It is desirable to include a mandated review period for purpose and goals. This may be set along a calendar timeline (such as every 5 years).

Organizational Structure

Trusts should operate with an executive director who is able to oversee day-to-day operations.

Some trust boards create a management committee to provide more routine direction for the executive director.

It is important to have an administrative assistant to ensure smooth functioning of routine tasks.

Trusts typically include a small suite of permanent full time employees dealing with mandated functions around human resources, financial management, and programs/projects. Human resource development is critical to maintaining corporate professionalism.

While trust revenues are to be directed to strategic investments, the size and nature of the organization's structure must reflect the tasks and purposes of the trust. While there is a recent 'trend' amongst some trusts, the arbitrary setting of caps on operations costs relative to income is not a well grounded way to balance professional organizational needs against tasks. Instead, an economic and organizational rationale must be applied. Staffing/organisational needs and expenses must be determined based on the tasks and purposes the trust wishes to carry out together with the requirements imposed by any legislation governing the trust.

The development of organizational structure and human resources capacity is critical to continuity within the trust and its activities.

Office space and secure file storage is also important to inspire confidence and ensure continuity.

- some regional trusts have dispersed their offices and even allocated different tasks to different offices.

Many technical support functions (ie: IT support for computer systems) can be competitively contracted if the trust has a stable and coherent organizational foundation.

Most trusts bring on part time or contract staff for limited periods to deal with specific projects, such as funding program application processing.

Another operating cost reduction opportunity is through the use of partnerships in program/project delivery.

- some trusts seek partnerships for the specific expertise they can bring to aspects of program delivery or management.

Program Delivery

Trusts have been effective in developing both loans as well as grants programming.

Some trusts are also involved in capital project investments.

Key trends in program delivery include that most trusts work towards community and economic sustainability. Specific programming includes 'quality of life' program spending, investments in economic/cultural infrastructure, support for education and training initiatives, as well as community economic planning studies.

Procedures for Funding

Many trusts opt for grant support of projects and programming. Funding for grants comes from investment revenues.

The management of loans (interest bearing and interest free) can become cumbersome over time.

To enhance flexibility, trusts identify clear program guidelines and criteria for applications. Samples of how to complete forms have proven to be of assistance.

To maintain flexibility, and support groups developing ideas previously rejected, trusts often look at having at least two funding deadlines per year.

To maintain focus, funding criteria needs to be expressly linked to the trust's purpose and goals.

To assist with evaluation, funding criteria must specify up front the identification of measurable outcomes.

Funding small projects as lump sum payments can remove paperwork, while for larger projects, trusts may want to disperse funds in small increments based upon performance reports.

Individual programs undertaken by the trust should have their own application processes. Within these different processes, forms and information should be coordinated where possible so that information tracking and recording can be standardized.

Online as well as paper submissions should be accepted.

Where trusts undertake very large funding programs, they may wish to initiate an initial screening exercise based on submission of a brief letter of intent. After initial screening, qualified applicants could then be invited to proceed with a full application (this is typically referred to as a two-stage application process).

In general, partnerships demonstrate broader support and can achieve efficiencies. If partnerships are to be a key piece of funding programs, then provision must be made for counting both direct and in-kind support. Auditing and evaluation processes through mid-term or final reports must account for these supports.

Approval of funding program applications needs to follow a clear and established criteria. For some trusts, regional equity is important, while for others, strategic regional benefits are the key.

The same applies for matching funds. Where a process and economic rationale are clear, then matching funds are appropriate.

Communication Mechanisms

Trusts will encounter significant difficulty where they treat communication mechanisms as an inexpensive afterthought. Transparency and openness are key elements to accountability for regional trusts. Ongoing liaison and communication (horizontally across communities and vertically with other levels of government/organizations) is expensive and may necessitate a permanent staff person.

All trusts are making extensive use of electronic communication means to reduce some costs. This includes email lists for targeted distributions, and websites for general posting of information and programming. In addition, many websites now include response and feedback mechanisms. Similarly, the websites for funding programs include direct links to application forms and FAQs to assist with completing those forms.

Never underestimate the value of in-person communication mechanisms in a rural and small town setting. Effective tools include open houses, meetings with local organizations and councils, and moving 'show' events such as board meetings around the constituency.

Communications mechanisms also cover responsibility for legislated communications such as annual reports, audit reports, and reports to senior government ministers where line reporting is required.

Finally, the communications task must be responsive to opportunities for promotion provided by routine or periodic events such as trade shows, conferences, and other such events.

Section II

Pros and Cons Comparison of the Alaska Permanent Fund, the Alberta Heritage Savings Trust Fund, and the Gwaii Trust Fund

This appendix to the theme summary is developed from two reports which examine the operation of the Alaska Permanent Fund, the Alberta Heritage Savings Trust Fund, and the Gwaii Trust Fund. These reports are:

> Warrack, A.A. and Keddie, R.R. (2002). *Natural Resource Trust Funds: A Comparison of Alberta and Alaska Resource Funds*. Edmonton, Alberta: Western Centre for Economic Research, University of Alberta, Number 72.
>
> *The Gwaii Trust: A Model for Albertans?* Expanding the Debate, Investing Wisely Project, Discussion Paper Series, Nu. 7 – November 2005, http://www.glenbow.org/about/president/gwaiiExtended.cfm.

The summary notes simply provide additional commentary for individuals looking to develop a new trust.

<u>Alaska Permanent Fund (APF)</u>

Pros

The Alaska Permanent Fund 'belongs to the people'. This means that not only are the revenue sources from the region's natural resource endowment, but the benefits and accountability structures link direct to Alaskan residents.

> - The APF is accountable to the public indirectly through elected representatives and legislated public reporting requirements.
>
> - The APF has extensive communication. Alaskans are very aware of the APF, its purpose, etc. Information on investments, expenditures, and future strategies is fully available and transparent to the public.
>
> - Funds are placed directly in to the hands of citizens through dividend cheques.

The Trust operates as an agency at arms length from the state and federal governments. Once funds are transferred into the APF, they are severed from the state government.

There is protection of the original funds by their placement in a "Principal Account". This means that the APF cannot spend any of the principal. Inflation proofing is also applied to that principal.

- Once monies are transferred into the Principal Account, they cannot be removed unless by a majority of all voters in a statewide plebiscite.

- Through inflation-proofing, the fund is designed to maintain its purchasing power.

Sole emphasis is on generating financial dividends for residents. One tool for maximizing commercial returns on investments is by providing incentives to financial managers/investors who exceed revenue targets.

- Revenue investments must follow a "prudent investor rule", which states that security of the principal outweighs the possibility of high returns and their associated costs.

- Investments are not made for social or political reasons, and all investments are made with the objective of earning a high level of return.

The APF has worked to develop a diversified investment portfolio, including real estate investments.

Cons

The APF has only two revenue streams. This includes resource royalties and interest earned from investments.

- During periods of low commodity prices for oil in the early 2000s, resource royalties were reduced and the state posted a deficit of over one billion dollars.

- Efforts to grow the resource revenue base means expanded oil and gas developments. Opposition from environmentalist and other organizations to future oil/gas exploration and development can limit the potential for growing resource royalty revenue sources.

With Alaskan residents receiving direct dividend payments as the only purpose of the fund, it is difficult to introduce any changes because individuals see tangible benefits 'in their pockets' rather than less tangible long term benefits that are more commonly derived through infrastructure and community/economic development investments. This feeds a temporary and transitory mentality.

- Funds placed directly into the hands of citizens are also a negative because it is left to individuals to make their own economic decisions regarding consumption and saving/investing. This may not translate into lasting benefits for communities when the flow of resource revenues ends.

Changes in the way the fund operates are very difficult to undertake as they require constitutional amendment (for fundamental changes) and/or statewide plebiscite.

> - Changes to the management functions of the fund can only occur through a 'separation of powers' process in Alaska. This would be slow, open, and subject to intense scrutiny and possible veto.

<u>Alberta Heritage Savings Trust Fund (AHSTF)</u>

Pros

Involvement by the provincial government in the Trust Fund meant that the goal of economic diversification as a focus for the Trust had more support and gained more general acceptance. Emphasis is on attempting to deploy 'social' dividends through investments in many physical and social infrastructure projects deemed of provincial importance.

> - It was argued that by diversifying the economy through public policy, the future of its citizens would be better protected against the volatility of a natural resource based economy.
>
> - Because the Alberta government is responsible for distributing the interest generated by the trust funds into strategic economic diversification and infrastructure investments on behalf of all citizens, tangible and longer-lasting benefits to communities would result.

With restructuring in 1999, the introduction of people from the private sector into the Operations Committee to review the Heritage Fund's business plans was a step towards increased accountability.

Changes to the Heritage Fund's investment policies, or even the structure of the fund itself, are easy to make.

> - This could be both a positive and a negative aspect. The ability to make changes to the trust through an Act of Government allows considerable flexibility to respond to emerging opportunities. However, the trust could also be dissolved and used to pay off government debt just as easily.

Cons

The Heritage Trust Fund belongs to, and is managed by, the Government of Alberta.

> - The economic diversification objective gave way in the late 1980s, early 1990s, to the Alberta government's desire to reduce its need to borrow from capital markets. Instead, the trust funds became used for financing regular Alberta

government budget expenditures. As well, a major portion of the trust was used to purchase debentures of provincial Crown corporations.

- These activities were administered through the government bureaucracy. This means that the Alberta government may redirect income from program allocations and may appropriate money from the principal.

- Only a portion of the Heritage Fund was invested on the basis of seeking a reasonable rate of return on investments.

- runs the risk of being seen as little more than a political lever used to implement and reinforce public policy decisions.

The initial instalment was not inflation-proofed until the restructuring of the Trust fund in 1999. A high period of inflation resulted in a substantial erosion of the Heritage Fund's purchasing power over time.

There are only two revenue streams – resource royalties and interest earned from investments.

The Oversight Committee, consisting of 9 MLAs (6 from the governing party and 3 from the opposition party), can be viewed as another layer of government added to the trust's governance.

Communication with the public is limited.

- Few Albertans know much about the management or operation of the Trust Fund.

- Accountability remains primarily within government, not to the public.

In the past, there was an AHSTF Standing Committee of the Legislature, which was to provide guidance to the treasurer's office in terms of investment strategies and performance. New legislation was enacted in 1997 and it has yet to be seen whether or not the new committee structure will have an effective influence on the direction of the Fund.

The original objectives of the Fund to save for the future and to increase the size of the fund through prudent investment policies were not maintained. These objectives have been modified or shifted during the life of the Fund. The Prudent Investment Rule was not always followed. Numerous loans were provided to provincial Crown corporations, some of which were program delivery entities and there was no expectation of 'loan' repayment. As well, the largest departure from the Fund's objectives was to stop transferring natural resource royalties into the fund. By 1987, the Fund no longer functioned as a savings vehicle.

Gwaii Trust

Pros

From its inception, it has been annually inflation-proofed based on the Consumer Price Index.

- The principal, and inflation-proofing, can never be touched, allocated, or expended.

- The remaining interest is used to pay administration costs (approx. $500,000 annually) and pay for fund authorized programs (approx. $3 million) as per the Gwaii Trust Business Plan.

The investment strategy is based on the premise of only investing in fixed income instruments and equities that provide sufficient security, and demonstrate a proven corporate record of socially-responsible investing.

A Gwaii Trust Business Plan is renewed every 5 years, with the direct input of all seven Island communities. This plan sets out funding priorities, and is driven by the consensual desire to create a sustainable economy.

Board members receive training on trust management and governance as part of capacity building.

There is considerable investment in building the human capacity of Haida Gwaii through educational and training support programs. These are targeted at a range of age groups.

The Gwaii Trust functions as a registered non-profit society in order to maximize tax exemptions.

The Trust's investment policies and procedures were developed in consultation with an actuary, and guidelines prescribe the investment performance objectives. The investment policy is reviewed annually.

- Investments are subject to the BC Trustee Act.

The Gwaii Trust may not redirect income from program allocations and it does not make business investments or loans.

Cons

The emphasis upon consensus based decision making, but runs the risk of slowing decision-making processes.

The emphasis upon community consultation is also laudable, but the demonstration of community support and the direction the community wishes to vote on particular items before the board may be difficult to operationalized and support on an ongoing basis.

Despite a number of mechanisms to be inclusive across the Islands, the Trust maintains only one small office in one community (at the north end of the Islands).