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Department of Fish and Game:

Land Management Endowment Program and Approach Overview

Presented to:

The Fish and Game Commission and

The Public

Overview of Department Presentation

- ☒ Overview of Endowment Programs
- ☒ Issues Considered and Addressed by the Department
- ☒ New Endowment Approach

Overview of Endowment Programs

- ☒ ***Purpose of Endowments***. The Department of Fish and Game (Department) is responsible for administering several regulatory programs that often require a permit applicant to mitigate impacts to natural resources including listed species. An example of this would be the Department issuing a California Endangered Species Act (CESA) incidental take permit. Permit conditions often include a requirement to acquire habitat lands to offset the impacts of lands lost or disturbed by the applicants proposed action. To meet the CESA adequate funding and full mitigation standards, the Department requires these acquired lands to be managed over time to maintain and improve habitat quality for the target species. An endowment is a method used to generate this annual management funding over long time horizons.

- ☒ ***Endowments Required for Many Different Purposes.*** The Department may require an endowment to fund management activities under a variety of permitting programs including CESA, Lake and Streambed 1600 permits, Natural Community Conservation Plans (NCCPs), and occasionally but rarely under CEQA. In addition, local governments, land trusts, other state and federal agencies, and others may use endowments as a tool to generate long-term management funding.

- ☒ ***Current Approaches.*** The Department's current endowment options are summarized in the figure below. In general, the state-managed option is more secure, poses less risk, but may not achieve the yields of a private sector third party manager. The third party approach is less secure, more risky, but may generate higher yields.

Department of Fish and Game: Current Major Endowment Programs	
State Managed Approach	- Endowment funds from applicants are deposited in the state treasury Special Deposit Fund. - Department is authorized to hold endowments in accordance with Govt. Code 16370-1 and F&G Code 13014. - Funds are invested in the Pooled Money Investment Account (PMIA) by Treasurer. - Approximately $53 million and 250 separate endowments are held to date. - Department reimburses third party land managers for annual expenses from endowment interest earnings. - High fund security, but generates low rate of return. - Statutory changes that allow for investment flexibility to be implemented soon.
Third Party Managed Approach	- Department receives applications from prospective third party endowment holders and conducts due diligence review to ensure they meet specific criteria designed to reduce risk of fund loss or mismanagement. - Once approved, endowment funds may be held and managed by a third party. - Investment directed by third party manager - Interest earnings on endowments are disbursed directly by the third party to land managers for land management purposes. - No specific funding for the Department program, staff redirected to task. - Lower security, but higher yield.

☒ ***Need for New Approach.***

- Recent exceptional economic pressures highlighting third-party risk
- Lack of infrastructure and expertise within the Department to effectively handle very high demand by third parties to hold endowments
- Statutory changes removed discrepancy between past state managed and third party managed approaches
- Quasi-governmental third-party partner acceptable to federal regulators and with a program tailored for mitigation endowments now available

☒ ***New Approach Effect.*** The change in the Department's approach described in this report addresses only endowments required under a CESA permit. Endowments required under NCCPs and endowments required of local government are addressed separately. The proposed approach change does not affect endowments required under other permit programs or by other entities.

Issues Considered and Addressed by the Department

Issue 1: Low Interest Returns in the State-held Endowment and Expendable Accounts

☒ ***The Issue:*** Since the 1990s, mitigation endowment monies associated with a Department CESA permit have been by law deposited in the Special Deposit Fund (SDF) which is invested in the Pooled Money Investment Account (PMIA) by the State Treasurer's Office. Various limitations on the investment of the funds and the short-term nature of the PMIA have resulted in a relatively low average rate of return (annual interest ranged from 1.4% to 4.5% in the last five years). The lower the rate earned on these funds, the higher the initial principal endowment costs for project proponents and less money available for land management activities.

Expected Endowment Contributions Based On Discount Rate			
Annual Required Spending	**Expected Annual Inflation**	**Expected Annual Average Return**	**Required Endowment**
$10,000	3%	4%	$1,000,000
$10,000	3%	5%	$500,000
$10,000	3%	6%	$333,333
$10,000	3%	7%	$250,000

Over the last two years, the Department has taken steps to address the issue of unacceptably low rates of return by seeking the assistance of other State agencies and external investment advisors. As a result, the Department initiated several changes summarized in the table below.

Special Deposit Fund Endowment and Expendable Accounts	
Fund Constraints Prior to 2009	Constrained by Government Code Section 16340 to: Invest only in securities, domestic bonds, savings and loans, credit unions, prime-rated commercial paper, negotiable CD's, etc. No equities. Current maximum yield term is five years for these invest instruments. Intended as a short-term, revolving fund within (PMIA). Average portfolio life in the PMIA is 5-7 months. Department endowment is the only long-term money in PMIA.
Fund flexibility After 2009	SB 1538 (enacted 2009) allows for fund investment flexibility as directed by Department. Provides for the Department to manage endowments within the SDF using funds other than the PMIA thus generating yields more comparable to those achieved by third party non-profits.

☒ ***Considerations:*** Post SB 1538, the Department can now achieve a rate of return comparable to third parties under a reasonable risk scenario. The SDF can now be a viable option for applicants while maintaining required transparency and accountability for state funds. Use of the SDF eliminates the need to create and maintain state infrastructure to conduct due diligence and monitoring of third party endowment holders.

<u>Issue 2:</u> Difficulties and Risks Involved in Implementing a Third Party Managed Approach

☒ ***The Issues:*** The SDF was secure but not competitive with the rate of return a private sector entity could realize. As a result, beginning in 2009, the Department began evaluating and conditionally approving third party endowment holders. In the meantime, statutory changes removed the discrepancy between past state-managed and third party-managed approaches and the significant economic downturn highlighted the risks of third party endowment management. In addition:

- **The Department Lacks Expertise to Review Third Party Applicants.** Despite the review criteria developed by its financial advisor, the Department recognized it lacks tools and expertise in house to determine if third party endowment managers are viable in the long-term or to evaluate and constrain investment policies.

- **Risks Have Been Real with Third Party Managed Approach.** While third party managed endowment interest returns are higher, investment strategies are often risky and subject to loss of principal.

  - Some conditionally approved third party managers have experienced significant endowment principal losses beyond those expected during the national economic crisis.

  - Examples of mismanagement call for ongoing and substantial oversight of each third party by the Department. One recent example is the collapse of The Environmental Trust, an organization holding endowments for state and federal mitigation. As a result of financial mismanagement, the organization filed for bankruptcy and the Department was forced to accept 11 mitigation properties with insufficient endowment funds for management.

- **There Are Significant Fiscal Costs for the Department.** Conducting due diligence review of third parties is costly and the Department lacks statutory authority to recover these costs. In addition, the cost of recovering compensation lands from a failed third party and managing these lands over time is un-funded. The Department underestimated the interest third parties would have in holding endowments.

  - 25 applications received to date, one primary third party, and eight other third parties conditionally approved

  - As the number of applications increase, so do the program costs and up to 100 entities have inquired and expressed interest in holding endowments.

- **A Quasi-governmental Third Party Partner is Available.** The National Fish and Wildlife Foundation (NFWF) manages a program tailored for mitigation endowments and has expressed interest in working with the Department as a single endowment management alternative to the SDF. This quasi-governmental organization has:

  - Served more than 10 years as a neutral third party fiduciary that specifically manages funds for the benefit of government stakeholders;

  - Congressional oversight and accountability and was specifically chartered as a quasi-governmental fiscal agent for environmental and conservation purposes;

- Demonstrated its acceptance as a fund manager by federal regulatory partners via a Memorandum of Agreement for the Renewable Energy Action Team.

☒ ***Considerations:*** To better coordinate with our federal partners who may require a similar endowment under the federal Endangered Species Act, to accommodate and streamline endowment management under the existing multi-agency conservation banking agreement, and to create additional flexibility for investment strategies for endowments, the Department intends to qualify a single third party endowment manager as an alternative to the SDF. The following table illustrates the differences between multiple and single third party endowment manager alternatives to the SDF:

Single Trustee for Endowments	Multiple Third Party Managed Approach
Requires internal governing body with relevant financial and legal skills	Requires reviewing body with relevant financial and legal skills
No direct state role in investment and disbursement	No direct state role in investment and disbursement
All new endowment funds under one entity	Endowments spread across a range of entities
Periodic oversight and monitoring of a single entity	Ongoing oversight and monitoring of multiple entities
Department costs minimal	Department costs substantial, with no viable funding options
Investment policy set by governing board, with Department guidance	Investment policy set by entity and reviewed by agency

Issue 3: Providing Flexibility for NCCP Partners

☒ ***The Issues:*** Permittees named in approved Natural Community Conservation Plans (NCCPs) retain responsibility for funding long-term land management yet may choose to establish an endowment to provide a predictable, long-term annual funding stream for managing lands conserved under the Plan.

☒ ***Considerations*:** The Department's approach for NCCP endowments stems from the long-term fiduciary and management relationship established between the NCCP permittee and the Department, which significantly reduces the risk of failure of an NCCP permittee to meet a long-term management obligation.

- NCCP permittees and public agencies created explicitly for implementation of the NCCP, for example, Joint Powers Authorities, may establish and hold their own endowments to help them fund perpetual management of lands conserved under the Plan.

- NCCP permittees may choose to direct their endowments for long-term land management to the Department to hold.

- NCCP pemittees may enlist as their endowment holder an existing nonprofit organization or with some limitations, provide for the creation of a nonprofit organization as part of their NCCP implementation, following Department due diligence guidance.

Issue 4: Constraints of Local Governments' Ability to Provide Endowments

☒ ***The Issue:*** State agencies, local governments and special districts have stated that providing a dedicated trust fund such as an endowment for long-term management is a budgetary challenge. Local governments in particular find it difficult to anticipate and budget for a one-time, large endowment as part of the annual local government budget process.

☒ ***Considerations:*** The Department developed, and is in the process of launching, a pilot local government endowment alternative program. This program provides an alternative to local government for funding long-term management requirements in a single budget year through an endowment. The program will be tested with local governments currently participating in the NCCP program because the Department and local government have a long-term fiduciary and management relationship established for the NCCP. This relationship significantly reduces the risk of failure of a local government to meet a long-term management obligation. The program includes the following elements:

- Department initially evaluates local government fiscal capabilities, history of meeting long-term permit obligations, and accounting standards.

- Local government conducts financial analysis to determine annual management costs for mitigation lands prior to implementing project.

- Local government provides annual pledge of revenue or enters into agreement with Department specifying financial mechanism for fulfilling its ongoing management obligations.

- Local government provides short term "contingency fund" and longer term assurances to fund management if local government fails to meet its annual obligations and does not provide a cure within a specified time period.

Conclusions:

Newly created flexibility in the SDF coupled with a single third party endowment manager alternative provide for reasonable returns on endowments, eliminate the risks and fiscal impacts to the state of qualifying numerous third party endowment managers, and provide for the transparency and accountability necessary for managing state funds. NCCP permittees are provided flexibility in holding endowments and a pilot program for an endowment alternative exists for local governments participating in the NCCP program.