Understanding UPMIFA

HIRTLE CALLAGHAN & CO
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The recent market drawdown has caused a great deal of anxiety among organizations that depend on endowment income to support their operations. As fiduciaries, it is important to understand your legal responsibilities as outlined in the Uniform Prudent Management of Institutional Funds Act (UPMIFA).

What is UPMIFA?

UPMIFA is the legal guidance to board members of charitable institutions on their fiduciary responsibility in the management and spending of endowment funds. While fiduciaries generally intend to be good stewards, there is often tension between how much to spend today versus save for tomorrow. Specifically, under UPMIFA, trustees are required to invest and spend the endowment at a rate that preserves the purchasing power of the principal over the long term.

UPMIFA (or some version of the Act) has been adopted in 49 states, with Pennsylvania being the sole exception. UPMIFA only applies to donor-restricted assets, which can sometimes add confusion for boards that tend to commingle their donor-restricted and unrestricted assets. In addition to making prudent investment management and spending decisions, boards have an obligation to make decisions that satisfy donor intent. Board members, and especially Investment Committee members, should make a practice of reviewing their donor-restricted assets and understanding what steps they should take to demonstrate compliance under UPMIFA.

Guidance on Managing Donor-Restricted Endowment Assets

Much attention is often paid to the sections of UPMIFA that relate to spending, but UPMIFA takes a holistic approach to managing endowment assets and provides guidance on the investment strategy. The Act lays out eight factors that boards must consider when investing the endowment. These are typical factors that Investment Committees discuss and thus may seem obvious. What is less obvious is that boards must be able to document that they have considered each one of these factors when establishing an asset allocation. Written documentation is key to UPMIFA compliance.

1. General economic conditions
2. Possible effect of inflation or deflation
3. Expected total return (must be high enough to preserve purchasing power)
4. Other resources of the institution
5. Tax consequences of investment decisions
6. Role of each investment within the overall investment portfolio
7. Needs of the institution and the fund to make distributions and to preserve capital
8. An asset's special relationship (if any) to institutional charitable purposes

Guidance on Endowment Spending

Deciding how much to spend from the endowment can be tricky for nonprofit boards, especially in difficult economic environments. In tough times, needs are often greater, and it is tempting to spend more from the endowment to meet those needs. However, UPMIFA offers clear guidance that trustees must spend prudently to preserve the endowment for the long term (or the time frame specified by the donor). There are seven factors that should guide endowment spending. The first four are the same as managing the endowment.

1. General economic conditions
2. Possible effect of inflation or deflation*
3. Expected total return
4. Other resources of the institution
5. ***Duration and preservation of the endowment fund***
6. ***Purposes of the institution and the endowment fund***
7. ***The institution's investment policy***

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There is no "correct" spending rate. To demonstrate prudence under UPMIFA, boards should be prepared to demonstrate that spending levels are in keeping with long-term return expectations, economic conditions and inflation. For instance, if you reasonably expect a portfolio return of 6% in an environment where inflation is 2%, then nonprofits should not draw more than 4% from their endowment. If your expected portfolio return is 8% and inflation is 3%, then the endowment draw should not exceed 5%.

Spending from Underwater Endowments

The section of UPMIFA that receives the most attention is the stipulation related to underwater endowments. Prior to UPMIFA, nonprofits were prohibited from spending from underwater endowments, making it extremely challenging to spend during tough markets. UPMIFA eliminated the prohibition on spending below the original value of the gift. While this is intended to give organization flexibility, it adds a great deal of complexity to the question of endowment spending when the market value is below the original gift value.

What Is an "Underwater" Endowment?

An endowment is deemed to be underwater when the fair market value of endowment is less than the value of the original gift.

The Act relies on fiduciaries to be "prudent" and puts the emphasis on maintaining purchasing power in perpetuity. Under UPMIFA, organizations can maintain appropriate levels of expenditures, even if that means spending principal. However, if a nonprofit's endowment falls below its historical gift value, the board must do the following:

1. **Explain and document why the current programmatic needs are so important that the risk of depletion is acceptable**
2. **Develop a plan for restoring the principal amount by fundraising, adopting an investment policy that is more aggressive, reducing spending rate or implementing other new revenue streams**
3. **Have a long-term plan that addresses how the organization will remain viable into the future**

If your organization cannot satisfy these requirements, then gift principal cannot be spent. As a trustee, it is your fiduciary responsibility to the donor to comply with UPMIFA even if compliance may not result in the ideal solution for the organization.

UPMIFA does not require you to spend "underwater" endowments and it is often best not to. If your nonprofit needs to spend from an underwater fund, it is best to seek legal advice.

Other Spending Considerations

Different states have adopted slight variations of UPMIFA, so it is important to reference your state-specific law. For example, some states have adopted a "presumption of imprudence" for spending rates in excess of 7%. If you are in one these states, you need additional documentation as to why spending in excess of 7% is prudent.

Boards should also be able to demonstrate that they have evaluated other organizational resources before spending more from the endowment. Some organizations also have shorter-term reserve assets, real estate, and other asset pools they can tap to respond to challenges. Endowed funds are a very long-term source of capital and must be preserved with that time horizon in mind.

UPMIFA does not eliminate the need to follow donor intent. For example, an endowed scholarship fund can only be used to fund scholarships. It cannot be spent in other ways, no matter how dire the circumstances at the institution.

Conclusion

Serving as a nonprofit board member can be challenging in tough economic times; the purpose of UPMIFA is to ensure trustees maintain their duty to preserve endowed assets for the long-term benefit of the organization, even in the most challenging of circumstances. Your duties as a trustee includes a fiduciary responsibility to donors that is an often overlooked component but is critical to complying with UPMIFA.

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Hirtle Callaghan can be a resource as you think through your endowment needs. We have an in-house Endowment Specialist, John Griffith, who can help you navigate issues related to your donor-restricted and unrestricted asset pools.

John has over 28 years of higher education experience and leads the firm's holistic planning process for institutions, working closely with Investment Committees to design customized investment programs that are fully aligned with their goals and risk tolerance. He also works directly with endowments on specific, client-driven projects. These projects help committees tackle key strategic issues, including spending policy, liquidity policy, debt ratios and covenants, capital campaigns, operating reserves and governance.

From 2003 until 2014, he was the Chief Financial Officer and Treasurer of Bryn Mawr College before joining Hirtle Callaghan. As the Treasurer at Bryn Mawr, he oversaw an $850 million endowment, managed cash, issued debt, and was responsible for budgeting and strategy planning. At Bryn Mawr, he assisted in modernizing and diversifying the endowment. During the latest recession, Bryn Mawr was one of only a few colleges whose debt rating was upgraded. Prior to Bryn Mawr, John spent 15 years in various financial roles at the University of New Hampshire. John started his career at Coopers & Lybrand.

John earned a Masters in Finance from Bentley University and a B.A. in Business Administration from the University of New Hampshire.

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