18266

ENVIRONMENT DEPARTMENT PAPERS

PAPER NO. 011

TOWARD ENVIRONMENTALLY AND SOCIALLY SUSTAINABLE DEVELOPMENT

BIODIVERSITY SERIES

# Issues and Options in the Design of GEF Supported Trust Funds for Biodiversity Conservation

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April 1995

ESD

Environmentally Sustainable Development

The World Bank

Global Environment Division

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8/96

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# Executive Summary

THE PURPOSE OF THIS PAPER IS TO EXPLORE THE CONCEPT OF CONSERVATION TRUST FUNDS, PARTICULARLY THOSE WHICH MIGHT BE SUPPORTED BY THE GLOBAL ENVIRONMENT FACILITY. This paper is neither a handbook nor a manual for generic trust fund design: each trust device will be tailored to the conservation, legal and financial settings in which it is created. Rather, this paper is aimed at familiarizing those who are seeking to establish sustainable finance mechanisms for conservation initiatives with the wide variety of design options and issues associated with trust funds. Trust funds are a relatively new concept for conservation use, and it is anticipated that client governments of the World Bank and GEF, as well as members of the donor community, will be interested in gaining familiarity with the trust fund mechanism and its special features. Updates to this paper are envisaged as the Bank and GEF gain experience with trust fund operation. Eleven trust-like funds have benefitted from GEF support during its 1991-94 Pilot Phase: of these, nine have received financing for fund design, five have received GEF capital contributions and one existing foundation will be strengthened.

The basic legal concept behind a trust device is that property is managed by one person or group (usually referred to as "trustee(s)") for the identified goals or benefit of a second person or group (usually referred to as "beneficiary(ies)"). A trust is thus a fiduciary relationship in which a trustee (or trustees) holds legal (custodial) title to specific property including money under a fiduciary duty to deal with it for the benefit of the beneficiaries, who hold equitable title. This is based on the Anglo-American law of trusts as developed and applied in the countries usually referred to as "common law" countries, essentially the current or former member countries of the Commonwealth and the United States. Some countries outside this group have adopted or adapted the Anglo-American trust concept for their own use, albeit with more limited scope. Others - even though they may share certain legal devices that are indeed comparable to the trust -have developed different instruments to serve the same purposes, especially as regards the public ("charitable") benefits envisaged in the context of the GEF supported trusts.

GEF trust funds for biodiversity conservation are not free-standing mechanisms. All are designed in conjunction with or as a subsequent stage of investment in the creation, reform or upgrading of conservation areas, systems or institutions. The trust fund is intended to sustain activities or actions already underway. Most have been designed to provide long term, sustained financing to meet recurrent costs of operating and maintaining protected areas and/or to ensure sustainable use of natural resources through community support. To accomplish their goals over time, the trust fund money assets are invested to earn interest and appreciate in market value. The assets in many cases are intended to grow in perpetuity and the income earned is disbursed for activities outlined in the legal agreement establishing the trust.

This type of trust fund has increasing appeal because of its obvious potential to stabilize the flow of resources to meet the recurrent costs of conservation initiatives over the long term. Nonetheless, however seductive the option may be to the conservation planner, GEF-supported trust funds are not a panacea and should be chosen only after a review of all other, often simpler means of securing recurrent cost financing have been examined and deemed infeasible or inappropriate. The disadvantages of conservation trust funds must also be considered. Trust funds which seek to meet recurrent costs from net income while maintaining the value of their assets in real terms in perpetuity are subject to complex financial and administrative arrangements. Furthermore, there is an opportunity cost of tying up the substantial capital required to generate very small amounts of net income.

Knowing when the high "price" of a trust fund needs to be paid is important; hence lower cost, equally sustainable alternative solutions deserve close review. Possible alternatives include: a political commitment by governments to long-term recurrent budget support, establishing user-charges consistent with demand and carrying capacity for the ecosystems under use, extracting resource rents for conservation, creating stable long-term programs of donor assistance and using variations on conventional trust funds.

For the design and structuring of a trust fund, a task manager should be supported by a team including one or more biodiversity specialists; a financial analyst who inter alia, will project income needs to aid in determining the size of the trust fund and the minimum acceptable returns on investments; legal counsel on domestic and offshore legal issues (most often in addition to the country lawyer), and possibly financial expertise to aid the local trust design team or Board of Directors with selection of an asset manager. The Bank's task team should work with a client country trust design team whose members represent the key stakeholders in an effectively functioning trust fund.

There is a wide range of trust fund forms and variations, with the basic elements necessary to make funds operational being the:

- trust instrument
- trustee(s)
- board of directors
- by-laws
- trust administration manual
- income distribution plan

Elements which are optional, but likely to be found in GEF supported trusts are an/a:

- asset manager
- asset management agreement
- trust administration unit
- trust adviser or special advisory committees

Major trust fund design issues which should be satisfactorily resolved include tax liability of trust income, attachment of assets, security of the assets and potential frustration of trust objectives. Input from competent and experienced legal counsel early in the preparation stage is critical to address these issues.

Most GEF supported trust funds will employ private sector asset managers to invest the trust assets. Asset managers would be selected on the basis of criteria to determine investment capability, experience and reputation and ability to ensure the safety and stability of the assets.

The trust fund designers, or board of trustees if the trust is already constituted, will need to provide guidance to an asset manager for the preparation of an investment strategy. Target returns (gross, real and real net), tolerable risk, the currency(ies) to which fund assets should be tied, income distribution and disbursement plans will set the basic parameters of such a strategy. Financial projections will serve to identify net income and minimum return needs.

Trust funds established with GEF support will, in almost all cases, continue operations after the life of the "project" which normally designs, vests and operates the trust fund for a few years. The "project life" is an arbitrary period of sufficient length that allows the Bank and donors to determine whether the trust is operating as designed and use of funds is consistent with the donors' requirements. In addition to standard supervision, a mid-term or other periodic review is a highly desirable feature of trust fund design. Even after the "project life", there should be provision for annual consultation with the main parties concerned (government, trustee(s), board of directors).

From the above, it becomes clear that trusts are highly individualized devices requiring considerable resources in terms of time and expertise for their design and management. An option which merits consideration is the creation of an "umbrella fund" which could be used to house individual conservation trust funds supported by GEF financing, and possibly other donor financing. Options might include establishing the umbrella fund either as a separate trust fund under the auspices of the

Bank or GEF, or as a separate legal entity. Each trust fund could be a restricted sub-account with its own purpose, beneficiary(ies) and local governing body — operating at the local level as a separate and independent trust.

The potential benefits of a such a Global Umbrella Fund (GUF) warrant further examination. Many of the difficult issues (tax liability, attachment) and time intensive design factors (customized trusts, selection of asset manager) which now absorb resources and lengthen the time required to establish a trust might find a simpler, more expedient resolution. However, the "costs" of establishing and operating a GUF must be examined and careful thought must be given to designing a GUF which could maintain many of the secondary benefits of trust funds which accrue to client governments.

# 1 Overview

This chapter introduces the concept of trust funds. *Annex 3* provides references for additional information on trust funds and related topics. A glossary of technical terms related to conservation trust funds follows the annexes for ease of reference. A bibliography is provided at the end of the report.

Each chapter opens with a box in the text, like this one, which outlines the contents of the chapter and highlights the major points.

### Summary of Main Points

- The concept behind a trust is that assets (GEF grants and/or other donor funds) are managed by one person or group (trustee(s)) on behalf of a second group (beneficiaries). Trust Funds are legal entities which, through their legal instruments and governing body, ensure that the assets or income from the assets is used for the specified objectives.

- Trust funds are being used more frequently to respond to conservation needs, particularly since few effective measures or mechanisms exist to ensure recurrent cost financing for conservation areas or institutions.

- This paper is aimed at familiarizing GEF task managers seeking to establish sustainable finance mechanisms for conservation projects with the wide variety of options and issues in designing trust funds. It is not, however, an exhaustive manual for establishing trust funds.

## Key questions addressed by this chapter:

- What is a trust fund?
- What is the purpose of this report?
- Where can additional information on trust funds be obtained?

## Introduction

Conservation trust funds can provide "an island of security" in an otherwise erratic budgetary and financial situation. Conservation of biological diversity has only recently been recognized as a national priority among many developing countries, and has therefore not benefitted from long-term investment support or the establishment of reliable revenue flows to support institutions. Trust funds of long-term duration can promote financial security to build local institutional capacity and community confidence.

While investment funding of conservation efforts is increasing, few measures or mechanisms exist to address recurrent cost financing needs. Recurrent costs refer to expenses such as park staff salaries, vehicle operation, small civil works such as maintenance of firebreaks or park infrastructure or other annual costs to operate or maintain a national park or conservation area. The need for a special financing mechanism to meet these needs arises because:

- general government budget resources are rarely adequate to meet recurrent cost financing needs even in key developmental sectors and are generally inadequate for conservation needs;
- few donors can fund operating costs for other than a limited project area or a medium-term project life;
- revenue generating potential or activities from ecologically sound management of the natural resources to be protected have not yet been developed or are minimal; and
- income generated from established ecotourism or other commercial, ecologically sound, ventures may be captured for general budgetary use, preventing capital replacement and or adequate maintenance of the conservation area(s).

Not all countries are suitable candidates for the trust fund mechanism. Alternatives which should be examined before recommending GEF support for a trust fund are discussed in Chapter 2, *Alternatives*, page 11.

## What is a Trust Fund?

The concept behind a trust is that assets (in this case, GEF grants and/or other donor funds) are managed by one person or a group (trustee(s)) on behalf of a second group (beneficiaries). A Trust Fund is thus a sum of money that is legally set aside and whose use is restricted to specific purposes for designated beneficiaries. A board of directors (sometimes called board of trustees) has the responsibility for the use of the trust fund's assets and has responsibility to follow the terms of the trust instrument (trust deed) which legally creates the trust and to comply with applicable laws. For the purposes of this paper, "trust fund" is a general term, and the legal structures of trust funds will vary from country to country. Chapter 3 outlines the different types of trust-like arrangements and their legal settings.

Most GEF trust funds for biodiversity conservation have been designed to provide long term, sustained financing to meet recurrent costs of operating and maintaining protected areas which have benefitted from some investment project support and/or to ensure sustainable use of natural resources through community support. To accomplish their goals over time, the money assets of the trust fund are invested to earn interest and appreciate in market value. In many cases, the assets are intended to grow in perpetuity, and the income earned is disbursed for activities outlined in the legal agreement establishing the trust. Thus far, most GEF supported trust funds established for natural resource conservation have been designed to disburse only the income earned from the assets. The principal, or corpus, of the fund remains intact and invested. Most of these trust funds reinvest some of the income earned to ensure that the corpus maintains its real value against inflation. Funds which may disburse part or all of their capital over time are mentioned briefly in *Other Financing Mechanisms*, page 7.

The two main components of a trust fund are the legal entity and its governing body (usually a board of directors), and the assets which the legal entity owns. The legal entity constituting the trust can be founded domestically or off-shore; it can be established within or outside the framework of a government organization. In some countries, the board of directors owns the assets; in others, another body, the trustee, has legal title to the assets but is governed by the board of directors. There are two common modalities to manage the assets. One is for the board of directors to hire an asset manager, either locally or off-shore, to directly invest the trust assets. The other is to establish a two-tier system with a locally based trust fund that is the sole beneficiary of a foreign-based (off-shore) trust which is created for the sole purpose of holding the assets.

Trust funds can be managed by a small board of directors which relies on the advice of a technical committee and local community groups or by a broad board which has substantive in-house expertise and therefore has lesser need for recourse to outside advice. The board may include representatives from local and international NGOs, local communities, international donors, local and national governments, and the scientific community. Chapters 4, 5 and 6 provide guidance on structuring and locating the trust fund and its assets.

## Purpose of This Report

The purpose of this paper is to explore the concept of conservation trust funds, particularly those which might be supported by the GEF. This paper is neither a handbook nor a manual for generic trust fund design: each trust device will be tailored to the conservation, legal and financial settings in which it is created. Rather, this paper is aimed at familiarizing those who are seeking to establish sustainable finance mechanisms for conservation initiatives with the wide variety of design options and issues associated with trust funds. Trust funds are a relatively new concept for conservation use, and it is anticipated that the World Bank and GEF's client governments, as well as members of the donor community, will be interested in gaining familiarity with the trust fund mechanism and its special features. Updates to this paper are envisaged as the Bank gains experience with trust fund operation. Eleven trust-like funds have benefitted from GEF support during its 1991-94 Pilot Phase: of these, nine have received financing for fund design; five have received GEF capital contributions and one existing foundation will be strengthened. Annex 1 provides a brief profile of each of these.

It is worth noting that GEF trust funds are not intended to be free-standing mechanisms. Most are designed in conjunction with or as a subsequent stage of investment in the creation, reform or upgrading of conservation areas, systems or institutions. The trust fund is intended to sustain activities or actions already underway.

As in any specialized field, jargon has infused much of the writing concerning conservation trust funds. Although every effort has been made to avoid the use of technical jargon in this report, it is recognized that some terms may be new to readers. Therefore, a glossary has been provided for easy reference at the end of the annexes to this paper.

## Other Financing Mechanisms

Through contacts with legal, financial and conservation specialists, task managers will be exposed to terms for financing mechanisms related to or serving the same function as trusts. Among these are:

- Foundations
- Endowments
- Sinking funds
- Revolving funds
- Debt-for-nature swaps
- Social Funds
- Local Currency Funds

**Foundations** are very similar vehicles to trust funds and can also meet the long term financing needs of conservation areas (see Chapter 3, The Civil Law "Foundation" as Functional Alternative, page 20). In civil law countries, there is no legal basis for trusts, so that establishing a charitable foundation may be a suitable alternative. Foundations can be designed by applying many of the principles for trust funds set out in this paper.

An **endowment** can be a grant or gift which may or may not have conditions attached. Endowments may be bestowed upon trust funds or foundations. This paper does not cover the creation of endowments.

Unlike trusts created in perpetuity, **Sinking Funds** are designed to disburse their entire principal over a fixed period of time. Sinking funds can also be set up using the trust-like arrangements described in this paper.

A **Revolving Fund** provides for new resources through the regular addition of resources to the trust assets or trust-like vehicle as existing funds are spent. The newly added funds can replenish or augment the original principal. Revolving funds are not covered in this paper.

**Debt-for-Nature Swaps** involve the purchase of developing country debt at a discounted value in the secondary debt market, and cancelling the debt in return for environment-related action on the part of the debtor nation. A brief overview of debt-for-nature swaps is provided in *Annex 6*.

**Social Funds** are generally sinking funds which make small distributions of funds to mitigate the social costs of economic adjustment and to support economic and social rehabilitation. Some GEF projects have incorporated a social fund component in support of alternative economic development activities aimed at relieving pressure on conservation areas. Some trust funds also dedicate a portion of their annual revenue flow to fund these activities. An overview of social funds is provided in *Annex 6* and additional references are given in *Annex 3*.

**Local Currency Funds** can operate like a trust fund, endowment, or social fund. The major distinction is that the assets are held in the local currency in an on-shore account. While the focus of GEF supported trust funds has been to meet conservation area recurrent costs, local currency funds often have different and broader primary objectives. The financial aspects of local currency trusts are discussed briefly in Chapter 5, *Security of Assets*, page 38, and Chapter 7, *Other Investment Issues*, page 59. See *Annex 3* for additional references.

# 2 Objectives of Trust Funds

This chapter examines the objectives and benefits of trust funds, some of the alternatives to trust funds, and the prerequisites for establishing a trust fund.

## Summary of Main Points

- The primary objective of GEF supported conservation trust funds is to provide a stable source of income to meet recurrent costs of conservation areas and institutions.

- Secondary benefits of conservation trust funds <u>may</u> be realized as a result of careful design and structuring of the trust fund. Some of the secondary benefits are:
  - More diverse types of activities can be funded than is possible with conventional investment lending
  - Financial flows can be matched to absorptive capacity
  - Capacity building is fostered
  - Broad participation is promoted
  - Co-financing possibilities are expanded

- A GEF supported trust fund should be proposed only after a review of all other, and often simpler means of securing recurrent cost financing have been examined and deemed infeasible or inappropriate. Alternative solutions which deserve close review include:
  - A government's political commitment to long-term recurrent budget support
  - User-charges consistent with demand and carrying capacity for the ecosystems under use and certainty that revenues will benefit conservation
  - Extracting resource rents for conservation
  - Stable long-term programs of donor assistance
  - Variations on conventional trust funds

- Once the trust option has been justified as the most appropriate solution, discussions with the client country government should be initiated to ascertain acceptance and support for the special conditions of trust arrangements.

## Key questions addressed by this chapter:

- What is the primary goal of GEF supported trust funds?
- What are possible secondary benefits of the trust fund mechanisms?
- Are there alternative means for financing recurrent costs?
- What special features of trust arrangements should be signalled to governments pior to proceeding with preparation of a trust-like alternative?

## The Primary Goal of GEF-Supported Trust Funds

The primary goal for GEF supported trust funds is to provide a stable source of finance to meet the recurrent costs of conservation areas and institutions. Most conservation activities require sustained funding of recurrent costs to secure a lasting impact.

Some projects will generate income, but rarely will they secure sufficient funds to cover all recurrent costs. In this instance, trust funds can be used to supplement the income generated and smooth out any fluctuations in income flow.

The nature of most GEF support (and most donor funding) is medium-term, usually covering a period of three to five years. Even in cases where donors do provide follow-up financing for projects, interruptions in funding flows between separate project cycles can be detrimental to progress achieved. Trust funds can ensure a smooth and regular financial flow to eliminate lapses.

A reliable source of income in the longer term should help develop stronger conservation related institutions which can benefit from program stability, undertake long range planning and attract, develop and retain quality personnel. Trust funds can therefore strengthen institutional capacity and bolster institutional stability.[1]

## Secondary Benefits of Conservation Trust Funds

The following points outline some of the secondary benefits and advantages which may flow from conservation trust funds:

- Trust funds, like other funding mechanisms, **can support many different types of activities,** provided they are permitted under the terms of the legal document establishing the trust and approved by the trust fund's board of directors. As noted above, some GEF trust funds have a portion of their annual revenue assigned to support community activities.

- Trust funds can **adapt to the absorptive capacity** of the recipient nation and implementing organizations. Absorptive capacity refers to the extent to which government agencies, NGOs and local groups can manage additional projects and programs. This depends to a large degree on how effectively agencies, institutions and local communities can organize for action. Trust funds give rise to more manageable disbursements which can be tailored to the capabilities of the recipients. For example a slow start up period with smaller disbursements for the first years of a project may be preferable until other components of the project are ready to receive more funding. Small flows carry no stigma of "slow disbursement" and unused revenue may be plowed back into the assets to earn additional income until needed.

- Critical to absorption are **expansion of participation** and **capacity building.** Local government, private sector, NGO and community level participants can be involved together at various levels of trust fund design and operation. It is common, and desirable, to have representation on the board of directors from among relevant government agencies, private enterprise, local communities and local and international NGOs. By involving local NGOs, community groups and local government in management, the use of trust funds can encourage ownership and train and empower a wide group of local stakeholders.

- Last, trust funds offer a new alternative for donors to **co-finance projects.** Trusts can be structured to accept, manage, and disburse additional grants from a variety of sources (public, private, domestic or international). The cofinancing can support recurrent costs, start-up costs, or entire sub-programs. Establishment of a trust may also be contingent on contributions from bilateral cofinancing sources, requiring the recipient government and partners to solicit donations. In Bhutan, disbursement of initial funds to the trust was conditional on the trust receiving contributions from other sources. In these cases, it must be clear whose responsibility it is to seek out and secure additional funds. Donors may also contribute technical assistance to initiate the trust formation process.

## Alternatives

Conservation trust funds have increasing appeal because of their obvious potential to stabilize the flow of resources to meet the recurrent costs of conservation initiatives over the long term. However seductive the option may be to the conservation planner, GEF-supported trust funds are not a panacea and should be chosen only after a review of all other, often simpler means of securing recurrent cost financing have been examined and deemed infeasible or inappropriate. The disadvantages of conservation trust funds must also be considered. Trust funds which seek to meet recurrent costs from net income while maintaining the value of their assets in real terms in perpetuity are subject to complex financial and administrative arrangements and the opportunity cost of tying up the substantial capital required to generate very small amounts of net income. As this paper demonstrates, net income may be very small, and even this net income may display annual fluctuations requiring considerable management skill for its stabilization. Where grant resources for biodiversity conservation are scarce - invariably the case - and biodiversity losses rapid, locking up large amounts of capital which could be otherwise applied to urgent conservation needs may not be the most efficient way to achieve biodiversity conservation.

Knowing when the high "price" of a trust fund needs to be paid is important, hence lower cost, equally sustainable alternative solutions deserve close review. Possible alternatives include, among others:

***Political commitment to long-term recurrent budget support:*** Especially in middle income countries with healthy economies and political stability, commitments to underwrite recurrent costs of conservation action as counterpart funding for donor supported capital costs of projects or programs may be consistent not only with social policy but may also be economically justified by returns to the economy from the consumption of the amenity preserved for this and future generations. The Governments of Mexico and Congo have made this judgement by agreeing to progressively finance an increasing proportion of recurrent costs of conservation activities as GEF financial support for these costs decreases over the project life.

***Establishing user-charges consistent with demand and carrying capacity for the ecosystems under use:*** Some protected areas or conservation sites have such high amenity value that most consumers are prepared to pay a user fee which could generate income in excess of recurrent financing requirements. In fact, user-charges and fees can be used to manage demand at the level of carrying capacity for various types of consumption, such as in the GEF Ecuador Galapagos NP and the GEF Czech Republic project (Krkonose Park) which have been designed to demonstrate this approach to park management. Nepal has recently initiated a fee in its world famous Chitwan National park which has this potential. Occasionally, revenue potential, particularly for a charismatic ecosystem, may so exceed the needs of that ecosystem, that surpluses can be contributed to parts of the national protected area systems which are not so well endowed with ecotourism potential.

***Extracting resource rents for conservation:*** Loss of biodiversity in production zones for forestry, mineral extraction or other uses may be taxed to provide a conservation levy for meeting recurrent costs of conservation in associated protected areas. Examples include proposed log export levies in Laos and PNG associated with Bank, UNDP and related GEF assistance to these countries. Levy revenues in these cases will be contributed to conservation funds to meet, inter alia, recurrent costs of conservation programs.

***Stable long-term programs of donor assistance:*** Where Governments are stable and absorptive capacity is adequate, a sequence of projects every 2 or 3 years in line with long term programs of conservation agreed with Governments may be more effective and less costly than single major investments in trust funds. For example, full expenditure of one million per year over ten years through a series of $2-3 million grants carefully tailored to implement a dynamically updated biodiversity action plan should have more impact than the net income of a ten million dollar trust fund over the same period which may be only $3 million.

***Variations on conventional trust funds:*** A sinking fund which seeks to exhaust its assets (both capital and interest) over a period of 10-20 years may be more appropriate than those operating only off net income if the biodiversity targeted for conservation is globally recognized. If major investment were attracted to trust funds now, the same biodiversity would be even more precious and attractive to investors in 20 years as loss of biodiversity globally inexorably proceeds elsewhere in the world. Sinking funds could provide the same funds as a series of small projects, but with the added security that funds are in place from the beginning and protected from economic and political volatility which may disrupt the sequence of lending in long term programs.

## Prerequisites for Discussion with Government

Once the alternatives described above have been reviewed and the trust option justified as the most appropriate arrangement, discussions with the client government should determine willingness to proceed and acceptance of special features of trust funds which may be particular to the trust device or to good practice which will ensure timely and effective trust establishment and operation. These are:

- that funds will be legally set aside (possibly even offshore), and decisions regarding their use will not be taken solely by the government.
- that management of the trust should include a broad representation of stakeholders (NGOs, local communities, private sector).
- the need to support the legal actions to create a trust or, if this is not a feature of the country's legal system, a trust-like arrangement.
- that a trust design committee, preferably with a broad representation of stakeholders, should be created in a timely manner to work with the Bank team.
- that exchanges of views with the Bank and or/donors may need to continue even after the designated project life.

[1] At the same time, however, entitlement should not be created; a system of monitoring and evaluation must be integrated and control mechanisms designed so that funding can be terminated if the objectives of the trust are not being met.

# 3 The Legal Framework

This chapter covers the legal aspects of trust devices.

## Summary of Main Points

- A trust is a fiduciary relationship in which a trustee (or trustees) holds legal (custodial) title to specific property including money under a fiduciary duty to deal with it for the benefit of the beneficiaries, who hold equitable title.
- The law of trusts has evolved in countries following common law tradition, but counterparts exist in other legal systems. Generally, an appropriate substitute for a trust in a civil law system is the foundation.
- Most GEF supported trusts will be public or "charitable", designating indefinite beneficiaries such as a social community or segment of a community.
- If a GEF supported trust is to benefit an insolvent recipient, it will be necessary to determine the lawful means to set up a trust to protect the assets from attachment before the GEF funds are disbursed by the Bank.
- It may be best to set up trusts as irrevocable to prevent the trustee from being pressured to dissolve the trust. In case the goals of the trust are not being met, power to redirect the funds can be addressed in the trust's by-laws.
- Before setting up a trust, there should be investigation of the relevant tax laws where the trust is established and where it will operate.
- In general, the legal instruments necessary to establish a trust fund include the trust deed and/or articles of incorporation, by-laws and, in some cases, a grant agreement

## Key questions addressed in this chapter:

- What is the legal concept behind a trust?
- What are the main categories of trusts?
- What are the requisites of a trust?
- What are the rules for establishing public or charitable trusts?
- What are the powers and duties of the trustee?
- What are the trust instruments?
- How can a trust be modified or terminated?
- What are the counterparts of trusts outside of common law countries?

## Brief History

The search for a means to create sustainable finance for conservation has lead to the recent use of an old financial instrument: trust funds and foundations. Private trust funds and foundations have been favored mechanisms of families (and communities) to create secure and lasting sources of income for future generations. In some cultures, private trust funds and foundations date back centuries. When men left England for the religious crusades, they 'gave' their land to a 'trustee' to ensure its safe keeping until they returned (or to pass to the next generation should the crusader not return).

Recently, innovative groups have been applying the trust fund concept to benefit conservation. Most of the early trust funds were born out of debt-for-nature swaps in Latin America and were local currency funds. (See Annex 6 for an overview of debt-for-nature swaps) The use of trust funds has now spread worldwide, and their applications have broadened to include off-shore hard currency trust funds and foundations. (See Annex 2 for information on non-GEF Trust Funds and Annex 3 for references to the USAID initiative.)

## Introduction to the Legal Aspects of Trust Devices

This chapter is meant to provide a non-lawyer with a basic understanding of the legal aspects of trust devices.

In its simplest form, the basic legal concept behind a trust device is as follows: property is managed by one person or group (usually referred to as "trustee(s)") for the identified goals or benefit of a second person or group (usually referred to as "beneficiary(ies)"). A trust thus is a fiduciary relationship in which a trustee (or trustees) holds legal (custodial) title to specific property including money under a fiduciary duty to deal with it for the benefit of the beneficiaries, who hold equitable title (including the right to sue the trustee to carry out the terms of the trust). This idea is often expressed as the "splitting of title" between legal obligations of the trustee and the beneficiary. Despite the apparent simplicity of this concept, however, complicated laws have developed over time to ensure that the rights and responsibilities concerned are properly implemented and protected, especially as they pertain to the obligations of the trustee. The lawyers drafting trust devices must be sure that the device complies with the letter of the law, otherwise a trust may fail if challenged in court.

While the law of trusts has evolved over centuries mainly in countries following the Anglo-American legal tradition, trust devices and their equivalents have also been developed or adapted in other countries. The present discussion, after summarizing the main legal features of the trust, will therefore conclude with a brief synopsis of its counterparts in other legal systems.

## Types of Trusts

A trust arises from the expressed intention of the owner of property to create a trust with respect to the property. Trusts fall into two categories: express trusts for private beneficiaries and public or charitable trusts. GEF trusts in common law countries should be designed as charitable trusts.

### *Private Trusts*

A private trust has one or more ascertainable persons as beneficiaries: for example, a trust to pay the trust income to the settlor's wife for life and at her death to distribute the remaining trust corpus to the settlor's descendants.

### *Public or "Charitable" Trusts*

A public or charitable trust is for a purpose which is classified as public or charitable (e.g., educational, or for the protection of the environment), and it must designate "indefinite" beneficiaries; i.e., a social community or a category or segment of such a community rather than individual persons. A charitable trust can be perpetual.

## Formal Requisites of Trusts

To have a trust, there must be a settlor (normally the GEF grant recipient) who delivers the trust property (e.g., GEF grant fund) to a trustee(s) with the intention to create a trust, whereupon the trustee(s) holds, manages, and administers the property for the benefit of designated beneficiaries. The trust must be for a lawful purpose.

### *The Trustee(s):*

There must be a trustee, or several cotrustees.

*Individual as trustee:* An individual named as a trustee must be of legal age and in most jurisdictions must have no disqualifying matters of record such as a criminal record.

A trustee is charged with the duty of effectively managing and administering the trust estate. There are three basic categories of trust administration problems: (1) the powers and duties of the trustee in handling trust affairs; (2)the duty of fairness to the beneficiary in investment decisions, and in apportioning receipts and expenses among the income and principal accounts; and (3) the rules prohibiting commingling or self-dealing by the trustee.

*Settlor can be trustee.* The settlor can be a cotrustee. He can even be the sole trustee provided that he is not the sole beneficiary of the trust.

*If sole trustee is also sole beneficiary, there is no trust.* The reason for this rule is that the trust relationship presupposes enforceable fiduciary duties; there must be someone who can hold the trustee accountable (suing, if necessary) to carry out the terms of the trust, and the same person cannot owe duties to himself as trustee.

*No trust fails for want of a trustee.* This is a basic rule of trust law. If the named trustee dies, resigns, or is removed for misfeasance, and the settler has not provided for designation of a successor trustee, the court will appoint someone to serve as trustee.

### *Nature of Trustee's Estate:*

- *Holds Legal Title, Not Beneficial Interest.* In other words, the Trustee's creditors ordinarily cannot satisfy their claims from trust assets (see "creditors' rights", page 16).

- *Title Terminates on Execution or Termination of Trust.* The common law typically holds that an express trust vests in the trustee the legal estate, subject only to the execution of the trust, and the beneficiary does not take any legal estate in the property but may enforce the trust. Further, when the purpose for which an express trust is created ceases, the estate of the trustee also ceases. On execution or termination of the trust the legal and beneficial estate vest in the person entitled thereto without the necessity of a reconveyance as the trustee's estate ceases by operation of the law. Moreover, the trustee's authority to administer the trust terminates on termination or execution of the trust, and any further acts with respect to assets (other than conveying them to the persons entitled) are improper.

### *The Trust Property*

There must be property subject to the trust.

*Basis of the requirement:* Because a trust involves a transfer of legal title in specific property to the trustee, and raises fiduciary duties in relation to specific property, there must be specific assets or property (also referred to as "corpus" or "principal") to which the trust duties relate.

*The trustee's fiduciary obligation to manage assets* for the benefit of a beneficiary must exist with respect to specific assets, so that the beneficiary who is not satisfied with the trustee's performance can pursue relief against a trustee failing to fulfill its fiduciary duties.

*Any property which settlor has power to convey can be subject of trust.* The trust property must be existing property which the settlor (the GEF grant recipient) has the power to convey. It need not be tangible property, but the settlor must have an assignable interest. Thus the subject matter of a trust can be a debt, whether or not represented by a note or writing, a contract, a patent or royalty interest, or a future interest.

## Beneficiaries

While a private express trust must be for ascertainable beneficiaries, for charitable trusts the rule is exactly the opposite: A central requirement for a charitable trust is that it be for a segment of society and an indefinite class of beneficiaries.

The settlor can be a beneficiary of the trust. He can even be the only beneficiary - so long as he is not also the only trustee.

## Trust Purposes

An express trust must state its purpose, which must be a lawful purpose. A trust will fail if its implementation will involve commission of a crime or tort.

### *Creditors' Rights*

Ordinarily, trust funds are exempt from being used to satisfy any money judgment for a debt owed by the settlor (i.e., the GEF grant recipient). However, some countries have recognized that the establishment of a trust should not be used to enable a settlor/debtor to shield assets from his creditors and have enacted legislation to provide the creditors with rights to "pierce" the trust "shield" and attach the trust assets. Thus, if the GEF- funded trust is to benefit an insolvent recipient, it will be necessary to determine the lawful means to set up a trust to protect the assets from attachment.

Of course, these steps should be taken before the GEF funds are transferred from the Bank (i.e., while they are still protected by the Bank's immunity) to the trustee. In such cases, the task manager should work closely with the operational lawyer as it may be necessary to investigate alternative sites for locating the trust assets or managing the means for distribution. In some cases, this may require enactment of legislation establishing or designating another entity as recipient.

## Distinct Rules for Public or Charitable Trusts

For the most part, when devising GEF-funded trust instruments in common law countries, it will be best if the trusts are legally recognized (sometimes by Charitable Trust Commissions) as "public" or "charitable trusts".[1] These trusts ordinarily have advantages for tax and control purposes.

The rules governing charitable trusts differ from those applicable to private express trusts in several important particulars.

### *Indefinite Beneficiaries*

The trust must be in favor of a reasonably large class of indefinite beneficiaries. Since environmental benefits by definition accrue to the community as a whole, GEF objectives will normally meet this requirement.

Since the purpose of a charitable trust is to benefit the community, the courts consider the community at large the beneficiary of a charitable trust rather than the particular individuals who happen to receive direct benefits. The rule requiring a private trust to have definite beneficiaries does not apply to charitable trusts.

### *Cy Pres Doctrine*

If the charitable purpose is accomplished or the designated charity goes out of existence, the court or other lawfully designated entity may redirect the trust to a purpose "as near as possible" to the charitable endeavor initially designated by the creator.

Where the specified charitable use is no longer possible or practical, the court must decide whether the settlor intended the trust to fail or would have wished the property to be devoted to a similar use. Of course, where the settlor has provided for such a contingency, his direction controls (see *Revocability*, page 17.). In formulating an alternative use for the trust property, the court must determine the settlor's primary purpose although his other purposes should be taken into account.

### *Perpetual Goals*

Provided the trust complies with the *cy près* doctrine, it can be designed to exist in perpetuity, unlike a private trust. However, a charitable trust must be strictly limited to those goals considered charitable, usually defined by statute to include religious, charitable, educational, or benevolent purposes, the promotion of health, and the accomplishment of governmental purposes, e.g., parks.

### *Revocability*

In order to create a revocable trust the creator must, in clear terms, reserve the power (can be reserved to the trustee) to revoke, alter, or amend the trust, and also to direct the income from the trust for life. (See *Termination According to the Trust Terms,* page 19). However, in the case of GEF, it may be best to set up trusts as irrevocable to prevent the trustee from being pressured to dissolve the trust. In case the goals of the trust are not being met, power to redirect the funds can be addressed in the trust's by-laws.

### *Enforcement by Attorney General*

In most common law countries, the Attorney General is commonly empowered to represent the beneficiaries of charitable trusts and has the duty to enforce the rights of such beneficiaries by appropriate proceedings in the courts. The Attorney General is an indispensable party to any suit concerning construction or enforcement of a charitable trust.

### *Tax Exemption*

Before setting up a trust, there should be investigation of the relevant tax laws where the trust is established and where it will operate. In some instances, especially if a non-governmental entity is to be the trustee, there may be domestic laws that might be interpreted by over-zealous tax collectors to justify the imposition of a tax on trust income or the receipt of grant funds. In most instances, contact with the relevant taxation or finance agency or ministry should enable the Bank to obtain the necessary assurances that a tax exemption will apply. For example, if the funds are invested in the U.S., to insure that the investment income is tax exempt, it would be necessary to obtain a tax exemption ruling under Section 892 of the Internal Revenue Code.

## The Trustee's Powers and Duties

### *Powers of the Trustee*

Depending upon the law in the jurisdiction where the trust is established, a trustee's power includes:

- To accept additions to any estate or trust.
- To take out and maintain fire, title, liability, casualty, or other insurance to protect property of estate or trust.
- With respect to any property in estate or trust except that specifically disposed of:
  - To take possession of, collect rents from, and manage same.
  - To sell at public or private sale on terms deemed appropriate to the trustee.
  - To lease property.
  - To mortgage.
- To make ordinary repairs.
- With respect to any mortgage held by the estate or trust, to continue same after maturity, with or without renewal or extension, on terms deemed appropriate to the trustee.
- To employ any bank as custodian of stocks or other securities held by the trustee.
- To enable the trustee's successor to succeed to all powers, duties, and discretions as were given to the original trustee (unless this result is expressly prohibited by a will or trust instrument).
- To contest, compromise, or otherwise settle claims.
- In some jurisdictions, to vote securities in person or by proxy (a departure from the "no delegation" rule of the common law.)
- To execute and deliver agreements, assignments, bills of sale, contracts, deeds, notes, receipts, and any other instrument necessary or appropriate for the administration of the estate or trust.

- To delegate authority to conduct ordinary business.
- To continue a business.
- To pay debts.
- To allocate expenses, income, and carrying charges and to apportion stock distributions as the trustee deems appropriate.
- To create reserves for depreciation, obsolescence, wasting assets.
- To rely on information deemed reliable without proper investigation.

### *Duties of the Trustee*

A trustee has the following duties and responsibilities, some expressly imposed by statute and others imposed by well-established case law principles:

- To take possession of trust property.
- Not to delegate his fiduciary responsibilities.
- To make periodic accountings.
- To exercise reasonable care and skill.
- To preserve trust property.
- To keep trust property separate. A trustee cannot invest or deposit such property in his own name individually; this must be done in his name as trustee. However, a corporate trustee can register stocks and other securities in the name of the nominee.
- To prevent breach of duty to co-trustee. If the trustee knows or should know of a breach of duty by a co-trustee, he is fully liable for any loss resulting from the breach.
- To make prudent investments. A trustee holding funds for investment may invest them in such securities as would be acquired by prudent men of discretion and intelligence seeking a reasonable income and preservation of their capital. The prudent investor investment standard is applicable to all trusts.

## Trust Instruments

### *Trust Deed*

Assuming the settlor (i.e., the GEF grant recipient) has identified the goals for which it wishes the funds to be managed by a trustee (or delegated agent of the trustees) for the beneficiaries' benefit - it will most likely wish that its goals be recorded in a binding trust instrument. In common law countries, this is most often referred to as the trust deed[2] and it may not be possible to operate a trust until the trust deed has been duly registered with the appropriate government office.

The trust deed is in essence a contract, which spells out the goals of the trust and the obligations to carry out those goals. Most often these obligations are owed by the trustees for the benefit of the beneficiaries - and these obligations may be enforceable in a court of law.

### *By-Laws*

While the trust deed spells out the trust's guiding principles and is meant to govern for the life of the trust, in certain instances it will be desirable to have "by-laws" govern the day-to-operations of the trust. In this manner, changes necessary to handle day-to-day operations do not require amending the trust deed. While the trust deed is drafted in order to bring the trust to life, the by-laws can be drafted after the trust is in operation and the trustees have an idea of how they wish to operate - either on their own or through a management board.

### *Grant Agreement*

A grant agreement may routinely be required as a means to transfer funds from a donor (such as the GEF) to the government or directly to the trust. If special rights are given to the grantor, for example to recall the funding if the objectives of the trust are frustrated, it must be spelled out in a Rights of the Grantor statement. This may not be possible in all legal jurisdictions. Where it is possible, the rights and conditions to revoke the funds are also spelled out in the trust deed.

## Modification and Termination

### *Invasion of Principal*

Most trusts give either the trustee or the beneficiary (or perhaps both of them) a discretionary power to "invade" the principal of the trust under certain circumstances. This gives a desirable flexibility to the trust arrangement and permits the trust to meet the beneficiary's needs should trust income be insufficient or should some emergency arise.

If an invasion power is given to the trustee to be exercised on behalf of the beneficiary, quite commonly a standard is inserted to give the trustee guidance as to when to exercise the power. (E.g., "so much of the principal as the trustee in its discretion deems appropriate to achieve the sustainable practices in the Bwindi Forest.")

### *Deviation from Trust's Terms: Emergency or Unforeseen Circumstances*

A court may permit deviation from trust terms if due to circumstances not known to or anticipated by the settlor, compliance with the trust will impair or frustrate the purpose of the trust. However, it takes a strong case to justify deviation from a trust's terms. The mere fact that an investment would be beneficial to the trust is not, in itself, a basis for permitting a deviation. It is only when the objectives of the trust would be defeated or substantially impaired that deviation is permitted.

### *Termination According to the Trust's Terms*

A trust will terminate automatically at the expiration of the time specified in the trust instrument. If there is no direction that the corpus be paid out to designated persons, the trustee holds control over the future distribution of the funds. If the settlor and all beneficiaries consent, a trust can be revoked or amended. The revocation or amendment must usually be acknowledged before a notary public.

## Trusts and their Counterparts Outside Common Law Countries

The foregoing discussion has been based on the Anglo-American law of trusts as developed and applied in the countries usually referred to as "common law" countries; i.e., essentially the current or former member countries of the Commonwealth and the United States. Some countries outside this group have adopted or adapted the Anglo-American trust concept for their own use, albeit with more limited scope. Others - even though they may share certain legal devices that are indeed comparable to the trust - have developed different instruments to serve the same purposes, especially as regards the public ("charitable") benefits envisaged in the context of the GEF.

### *Adaptations of the Common Law Trust*

A number of countries outside the "common law" group have found it convenient to introduce the (suitably modified) trust concept by way of national legislation more or less patterned on Anglo-American experience. Examples are Japan, Liechtenstein and Mexico, all with highly advanced trust statutes dating back to the 1920s. Several other countries, especially in Latin America, permit and facilitate the establishment of trusts, though primarily for private beneficiaries and often expressly excluding charitable trusts (e.g., Panama and Venezuela); others have adopted trust features for limited sectors of the economy, such as mortgage-secured bonds (Brazil, Chile, Colombia) or certain banking operations (Ecuador, Peru, Nicaragua). Even though trust devices are thus, in principle at least, available in these jurisdictions, these may not be suitable for GEF purposes and/or require careful study of the applicable legislation and regulatory practice.

### *Limited Historical Parallels*

It is frequently pointed out that the trust concept has historical antecedents in different legal systems, and hence should also be adaptable for contemporary use in the different countries concerned. For example, the above-mentioned Latin American trust legislation uses the terms *fiducia* and *fideicomiso* which can be referenced back to ancient Roman law, and hence to a common tradition shared by all countries deriving their legal system from European civil law. Closer scrutiny of these concepts, however, and their modern-day European equivalents[3] reveals that their scope is far more limited than the common law trust, especially as regards the rights of the beneficiaries.

Similar parallels have been drawn to ancient institutions of Islamic law, such as the *waqf*, which historically served as a legal device for the establishment of (perpetual and irrevocable) public charities.[4] While environmental benefits would qualify for the legitimate purposes of a *waqf*, several contemporary Islamic countries have severely restricted or regulated the economic use of this traditional instrument, which may thus be virtually superseded by modern (secular) legislation.

### *The Civil Law "Foundation" as Functional Alternative*

The most appropriate substitute for charitable trusts in "civil law" systems generally is the "foundation" (*fondation, fundación, Stiftung, stichting*), which exists in most modern legal systems based on continental European law and is widely used by major environmental institutions in these countries; for example, the World Wide Fund for Nature (formerly the World Wildlife Fund, WWF) was established in 1961 as a foundation under article 80 of the Swiss Civil Code.

The establishment of a civil law foundation normally requires approval by the competent government agency, and charitable foundations are under strict government supervision (e.g., in Switzerland: annual audits, and periodic official attendance at Board meetings). Not unlike the common law *cy près* doctrine, the competent government agency may change the charitable purpose of the foundation if the purpose originally specified by the settlor can no longer be achieved (e.g., in Switzerland: articles 83 and 86 of the Civil Code).

One major difference, as compared to common law trusts, is that foundations acquire a separate legal personality of their own, including the capacity to own property etc., which is exercised by a corporate Board. This legal independence also serves to shield the foundation's property against claims by the founding donor's creditors except in the case where (as for donations) the donor can be shown to have used the very establishment of the foundation as a means to defraud prior creditors (Swiss Civil Code article 82). Once established, the foundation can only be revoked by a formal public act (at the request of the competent government agency or of any interested person, if the purpose of the foundation has become unattainable; or by judicial decision if the purpose has become illegal, see Swiss Civil Code articles 88-89).

## Transnational Aspects

Normally, a trust is intended to be effective in the jurisdiction where it is established. Whenever a trust (or foundation) established in one jurisdiction is expected to have legal effects also in other countries (as in the case of the GEF Eastern Carpathian Foundation), special aspects of private international law (conflict of laws) need to be taken into account, including the recognition abroad of the trust and of legal acts related to it. In order to avoid disputes it is advisable to specify in the trust deed which national law shall determine the validity, administration and construction of the trust (choice-of-law clause). The 1985 Hague *Convention on the Law Applicable to Trusts and Their Recognition* facilitates mutual recognition between countries which have become parties to it.

**An Example of Legal Requirements in Poland**

Polish law requires that any foundation in which a Polish concern is involved must have a representative office in Poland. To accommodate this, the Foundation for Eastern Carpathian Biodiversity Conservation framework states that the Foundation may establish branches and representative offices in any of the three participating nations, as decided by the board of directors or as required by law.

[1] This recognition may require a decree through a Charitable Trust Commission or Ministry of Finance, Taxation or Attorney General.

[2] Copies of trust instruments may be obtained through the Bank's Legal Department Environmental Affairs Unit (LEGEN) or Operations (LEGOP).

[3] E.g., the *prete-nom* in France, the *Treuhand* in Germany, the *bewind* in the Netherlands, or other possible combinations of agency, contract and bailment law, which cannot be considered here in detail.

[4] According to the Ghayat el-Bayan collection (1369 A.D.), the Prophet is reported to have defined a *waqf* as follows: "Tie up the property and devote the usufruct to human beings and it is not to be sold or made the subject of gift or inheritance; devote its produce to your children, your kindred, and the poor in the way of Allah."

# 4 Designing the Trust

This chapter focuses on designing and structuring trust funds. It addresses the question of minimum size and the components which most trust funds will require to be operational.

## Summary of Main Points

- The minimum size of a trust fund should be determined taking into account (1) reasonable returns (interest, dividends and capital appreciation) on invested assets, (2) expenditures (income for conservation activities, plus fees, administrative and tax charges and any plowback to the corpus necessary to maintain the real value of the trust assets).
- The components needed to operate a GEF supported trust fund will vary, but in general will include a trust instrument, trustee, board of directors, by-laws, a trust administration manual and a plan for income distribution. In most cases, the trust will also require an asset manager, an asset management agreement, and a trust administration unit. Depending on in-country expertise available, a trust adviser or other special advisory committees reporting to the board may be desirable.
- The income distribution plan should include strategies for periods of lower than targeted or negative return on assets.

## Key questions addressed in this chapter:

- What are the determinants of minimum size for a trust fund or asset management account?
- What strategies can be followed for trusts whose return on assets does not meet expectations?
- What are the roles of the trustees, board of directors, asset manager, trust administration unit and trust adviser(s)?
- What are the considerations for an income distribution plan?

## Minimum Viable Size for a Trust Fund

The net income available for conservation activities is derived after (1) either capital appreciation or a portion of the income earned on investments is added to the corpus to maintain its real value and (2) fees, administrative costs and taxes are deducted from the total income earned on the invested assets. When determining the minimum start-up size for a trust fund, at least one firm source of funding is generally known and can be used as the point of departure for initial iterations to project the viable trust fund size. Estimated net income required and expenditures and assumptions on expected annual return can be used to determine what the minimum viable size of the trust fund must be in order to meet conservation needs. The following formulae can be used to estimate trust fund size and identify acceptable target returns to invested assets.

**Criterion One: Minimum Fund Size**

$$\frac{\text{Required annual income (net income + plowback + expenses)}}{\text{Expected return on assets}^{1}} = \text{Minimum start-up size for trust}$$

**Criterion Two: Satisfactory Net Income Requirement**

Plowback + expenses (fees + administrative charges + taxes) < Net income required for conservation activities

Some trust funds will be established initially with a small capital base and expectations to grow the capital base by either additional donor contributions or a return to the corpus of a larger portion of income earned on investments, and thus will not meet the above test. In this case, the medium term objective of trust management should be that the corpus maintain its real value while net income becomes progressively greater than charges against the trust assets. The longer-term objective would be to secure additional contributions from donors.

**Criterion Three: Efficient Asset Management Criterion**

The size of the trust fund capital (corpus) must also take into account the incentive structure for asset managers to take on the trust account as a client. Considerations are somewhat different for off-shore asset management, a trust company establishing an off-shore trust fund or foundation and asset management by a multilateral aid agency.

### *Minimum for simple asset management account*

Virtually any international asset manager can manage the assets of an off-shore trust or of a domestic trust fund which has its assets managed off-shore. There are two types of asset management: private client and institutional.

- **Private client** asset management offers services for individuals and usually manages smaller accounts. Fees are higher than for larger institutional accounts. The consensus is that for private client management, an account under US$1 million should not be invested in individual stocks and bonds because ample diversification can not be obtained for such small amounts. (see Chapter 7, *Diversification*, page 54). A more realistic minimum, based on a general consensus of private client asset managers, is US$ 5 million. With thisamount the investments can be well diversified and the account could produce a satisfactory net annual income. Private client services usually include an annual visit from the asset manager to the board of directors, semi-annual or quarterly letters concerning the market conditions, and direct personal response to any inquiries. Commingled funds or mutual funds may be effective options for accounts with less than US$ 5 million.

- **Institutional asset management accounts** serve small businesses and major corporations. The service is less personal and fees are lower. The bank relies on returns to scale to make its profits on institutional accounts; the client can usually expect a slightly higher return due to reduced fees and better diversification of a larger account. The minimum for institutional clients is US$ 10 to US$ 20 million. However, some banks may be interested in establishing a relationship with GEF funded projects and may offer institutional management services for smaller accounts.

### *Minimum for establishing an off-shore trust*

Fees involved in establishing an off-shore trust are usually a percentage of the assets, plus any separate legal fees. The legal fees and minimum size of a trust depend directly on the complexity of the instrument required. For example, a simple family trust which uses standardized forms will be charged very low fees and therefore may operate viably for as little as $500,000. Management fees and start-up expenses will be increased if a customized trust deed is required and/or the bank feels frequent contact with the board of directors is necessary to fulfill their obligations as trustees. Conservation trust funds will require customized legal work which may be complex. In general, a revocable trust dictates more involvement by the trustee and therefore potentially a slightly higher fee. Furthermore, banks use a sliding scale of fees which favors larger trust funds. Each case will vary, however a rough census of trust managers in the private sector shows that any trust which cannot use standardized forms should not be under $ 5 million.

The factors which a trust company will consider when negotiating fees for a given trust size are:

- who will manage the assets (if the bank does, better terms can be reached);
- how often interaction will be required with the board of directors;
- what are the terms of revocability of the trust.

See Chapter 6, *Turning to the Private Sector to Establish the Trust Vehicle*, page 49, on the role of commercial banks for establishing trust funds.

### *Minimum for an account with a multilateral agency*

Some of multilateral agencies, such as UNDP, can manage the assets of conservation trust funds. These agencies administer very large sums of money which are usually invested in blocks of US$ 3-5 million per type of investment (e.g. US$ 5 million of one bond). This practice may not be optimal for conservation trusts: an account with US$ 10 million could only be invested in two or three financial instruments, and would not benefit from wide diversification of investments. Furthermore, some of these agencies are limited to investing in short-term fixed income securities.

General conclusions on minimum account size for asset management can be made as follows:

| | |
|---|---|
| A simple asset management account, managed as a private client | US$ 5 Million |
| A simple asset management account, managed as an institutional account | US$ 10 Million |
| Off-shore trust fund, managed by a commercial bank | US$ 10 Million |
| Trust and assets managed by multilateral agency | Large trust funds, generally exceeding US$ 10 Million |

## Strategies in the Event of Funding Shortfalls

In the event a donor or donors withdraw their commitment(s) to fund a trust, the minimum trust size criterion will no longer be met. Experience has shown that the time to obtain commitments from other donors can be between two months and two years.

The following options should be reviewed should this situation arise:

- can donor funds be found for an "investment" project to cover costs while the fund assets grow and other donors identified?
- can an asset management option be found which could allow a smaller fund to be cost-effective and viable, i.e. can start-up occur with reduced expenses and income during the period when additional funds can be sought and secured?

Strategies adapted by existing Trust Funds are given in Box 4.1.

Whatever interim strategy is pursued, it is important that the responsibility (government, trust entity, donor agencies or joint) for seeking out and securing donor funds be determined early in the dialogue on trust design.

**Box 4.1 Strategies for Trusts Whose Funding Levels Do Not Meet Original Expectations**

| Trust Fund | Expected Funds | Starting Funds | Strategy |
|---|---|---|---|
| BTF (Bhutan) | US$ 12 | US $ 9.5 | Established trust with US $9.5; seeking additional funds from bi-laterals |
| MBIFCT (Uganda) | US$ 4 million | US$ 4 million | Would like to increase size of trust in year 3; USAID covers administrative expenses for first two years to allow asset growth. |

## Components - Putting the Parts Together

Despite the wide range of trust fund forms and variations, the basic elements necessary to make funds operational are:

- trust instrument
- trustee(s)
- board of directors
- by-laws
- trust administration manual
- income distribution plan

Elements which are optional, but likely to be found in GEF supported trusts are:

- asset manager
- asset management agreement
- trust administration unit
- a trust adviser or special advisory committees

While Chapter 3 sets out the legal principles governing the roles and responsibilities of the trustee and board of directors, the following paragraphs highlight practical aspects and examples to guide the trust design team.

*The Trust Instrument.* In most cases, this document (be it a trust deed, articles of incorporation, decree law, etc.) will establish the trust or trust-like alternative, outlining its objective(s) and scope of activities, beneficiary(ies), governance structure and initial capital. Input from competent and experienced legal counsel early in the preparation of this document is critical[2].

*The Trustee(s).* The Trustee(s) will receive legal title to the GEF grant either directly or through a settlor (often a government recipient of the GEF grant).[3] The trustee's powers and duties will be determined by the law in the jurisdiction in which the trust is established (see Chapter 3, *The Trustee's Powers & Duties*, page 17, for a list of common powers and duties). Trustees can operate on their own or through a board of directors. In the latter case, local law will dictate the exact roles and relations between the trustees and board of directors for domestic trusts. For example, in Uganda, the MBIFCT trustees are a subset of the board of directors. In other cases, the trustee(s) is(are) entirely separate from the board of directors. For example, in Bolivia the government entity, FONAMA and the commercial bank which will house the offshore trust account are co-trustees of the fund known as CF/SNAP.

*Board of Directors.* Experience has shown that designing the board of directors is often the most time consuming part of establishing a trust fund. Extreme care must be taken so that the Board remains:

- **functional** (not too large, not too political, with reasonable meeting periodicity) etc);
- has an **internal check and balance system** to prevent domination by one constituency (voting system, rotating membership).
- **represents the critical stakeholders** for the project (local government, local communities and NGOs, national government, conservation agencies, private sector).
- **embodies or has access to special expertise** (conservation, financial, and legal).

Two key considerations in structuring the board are membership and voting systems. The issues below can be addressed by the way membership and/or voting systems are structured:

- perception that the trust fund is "too close to the government", (or an NGO or any other organization);
- assertion of influence by one or more parties for their special interests;
- representation of international donors, possibly in a passive manner or in a rotating seat;
- inclusion of local communities and regional representatives;
- flexibility to change priority activities supported by the trust fund as circumstances and needs change;

The board must represent at all times a broad spectrum of legitimate interests, requiring that its structure be formulated with this in mind. Ways to achieve this include:

*Having a two-tier board structure:* a national or multi-national conservation efforts may consider regional boards to review local project proposals and perform other relevant functions. The regional boards would report to the national board.

*Having ex-oficio board members:* For example, Uganda's MBIFCT board will initially include five non-voting members who do not need to be directly involved in trust decision-making, but have a specific need for ongoing knowledge of trust operations (see Box 4.2).

*Using advisory groups or special committees:* When there is need for special expertise to "round out" the Board, an advisory group such as a scientific and technical advisory panel or group of businessmen and social leaders could be created as a permanent structure. When links to beneficiaries need to be strengthened beyond the one or two board members who represent them, a steering committee comprised of local stakeholders, can be constituted to report to the board periodically. Uganda's MBIFCT will have a formal Local Community Steering Committee to ensure vital interaction with local communities.

The structure of the board must maintain a balance of interests in the long-run. This can be done through:

*Rotating membership for:*

- international donors. The representative could also aid in coordinating donor policy.
- local private sector as donors to the fund or subject to taxes and fees earmarked for the fund. Representatives from concerned businesses and industries might aid information flow and good will.

*Special voting systems:*

- granting certain members veto power on certain issues (e.g. to dissolve the trust)
- requiring super-majorities on certain issues
- using consensus, simple and weighted majroities depending on the decisions required

**Uganda's MBIFCT Local Community Steering Committee**

The LCSC ensures that a significant part of decision making for the MBIFCT is carried out by those most directly concerned because they live and work in the project area. The LCSC will be one of the principle means by which the MBIFCT interacts with local communities: it will screen all proposals for grants for community development projects, approve small grants (up to $1000) directly and forward larger grant proposals to the board of directors for approval.

The LCSC will also help raise awareness in the community and serve as a contact point and source of information about the Trust, as well as provide feedback from local communities to the board. To ensure linkage and continuity, three community representative members of the LCSC will be selected by the full LCSC to serve as voting members of the board.

Like the board, the LCSC will include representation of the three main interest groups: government, local communities and NGOs. It's composition is designed to meet several key objectives:

- To provide fair representation of the diverse communities and social groups in the MBIFCT catchment area.
- To ensure balance of power among the various stakeholders.
- To help mobilize community support for conservation generally and projects specifically funded by MBIFCT, to ensure that funded projects remain sustainable after MBIFCT funding is finished.
- To help maintain the link between economic benefits from the Trust and conservation of the Bwindi Impenetrable and Mgahinga Gorilla National Parks, by involving interest groups in the area who can make special commitments to support conservation efforts.
- To retain sufficient flexibility to accommodate possible changes in local political structures and stakeholder groups.

The operational guidelines of the Trust Administration Manual allow for flexibility in the process of selection of community representatives, geographic distribution of representatives and composition of representation.

## Box 4.2 Examples of Directors Structures

### Board of Directors
### Two Examples to Meet Different Needs

A Domestic Trust and a Multi-National or Regional Trust will require different representation on the board of directors.

A **domestic trust** board will have a broad representation and aim at balancing diverse local and regional interests by including:

- Local representatives (regional, if the trust is national in scope)
- Appropriate government agencies
- Local NGOs
- International NGOs active in each area
- Research institutes active in each area

A **multi-national trust** needs to strike a balance between the participating nations and include other representatives who transcend national interests. Such a board might be composed of:

- Equal representation from each nation
- International NGOs active in the region but headquartered outside of the involved countries
- Research institutes active in the region

### MBIFCT:
### A Domestic Trust

Board of directors comprises one representative of the following:

*Trustees*
- Uganda National Parks
- The Forest Department
- National Conservation NGO
- An International NGO
- Research institution active in the area
- The private sector (tourism)
- Residents of three districts surrounding the conservation areas

*Ex-oficio Members of the Board*
- Ministry of Tourism, Wildlife and Antiquities
- Ministry of Finance and Economic Planning
- Solicitor General's Office
- An active international donor

*Voting System:*
Trustees are voting members of the board with one vote per trustee.

### Eastern Carpathian Foundation:
### A Tri-national Foundation

Board of directors will comprise of the following:

*Category One*
- 4 Members appointed by each of the nations, including:
  - a representative of the Ministry of the Environment
  - a local biological scientist
  - a representative from the impacted national park or protected reserve

*Category Two*
- One member appointed by WWF
- One member appointed by the MacArthur Foundation

*Voting:*
All members vote, however, decisions require affirmative votes of seven members in the first category and one in the second category.

*By-Laws.* The by-laws provide the operational guidelines and procedures for the trust, such as members' functions and responsibilities in relation to decision-making, administration; financial management including appointment and monitoring of the asset manager, financial reporting and auditing, review of documents and reports, legal responsibilities, as well as procedures for meetings including voting systems. In many cases, the by-laws cover explicitly the broad topics of the trust deed. The advantage of having the detail in the by-laws is that they are easier to modify than the trust deed, as they are created by the trust and do not have the public law status of the trust deed.

*Trust Administration Manual.* This document is drafted under the guidance of the trustee and lays out in detail the administration of the activities funded by the trust fund, the governance of the trust fund, the interaction between and the responsibilities of the various bodies and parties involved in or benefitting from the trust fund. Specific items covered might include:

- Terms of reference for any special committees, the trust administration unit, advisers
- Guidelines for identifying, developing and submitting proposals for activities to be funded
- Eligibility criteria (if a portion of the trust income will finance community, NGO or other non-governmental institutions through small grants)
- Project selection criteria
- Financial recording, reporting and auditing
- Disbursement arrangements and procedures
- Procurement guidelines
- Monitoring and evaluation

**Special Considerations for Community Support Components.** For those trust funds which will support community, NGO or other conservation institution activities, attention will need to be given to defining arrangements in the trust administration manual which ensure that funds reach field level. This is particularly problematic when support is being provided to remote areas. Experience with social funds and other projects incorporating community participation has shown that the inability to disburse small

### Eligibility Criteria

In addition to funding recurrent costs of conservation areas, some GEF trust funds may also allocate a portion of their net income as small grants to support alternative livelihood and other community directed activities as well as conservation groups and institutions. In such cases, the trust administration manual may identity which groups could be eligible and how these groups are defined. Eligible groups might include: village councils, traditional associations, farmers' organizations, co-operatives, women's groups, community-based organizations and other NGOs, scientific and technical institutions (research, data collection, training, education activities)

To ensure that a "group" can work together as such to implement a project successfully, definitions such as the following may be specified:

<u>NGOs</u>: might be required to have a basic organizational structure or constitution, at least a year's experience with relevant activities, demonstrated capacity in project management, reporting and accounting capacity.

<u>Community Groups</u>: might be required to have at least 10 members, a basic organizational structure and/or charter, and have been functioning as a group for a minimum of 6 months

*Source: "Criteria and Procedures for Choosing Projects Proposed by Community Groups and NGOs", The GEF NGO Small Grants Programme, UNDP* amounts of funds in a timely manner at the field level to be a recurrent and pervasive problem. Lessons drawn from experience with social funds indicate that the following can be useful in ensuring that communities know how to access funds and that funds can reach the local level in a timely and effective manner:

- creating partnerships between communities and NGOs or established cooperatives can facilitate preparation of proposals, communications with the trust's administrative body, flow of funds and accountability. When substantial support is envisaged over a relatively long period, the creation of a local trust administration unit could also be considered.

- making appropriate sections of the trust administration manual available to communities to further their understanding of the process, procedures and expectations of trust management.

- devising simple rules of management and transparency according to which the community is accountable to the trust fund.

- working out modalities for disbursing funds at the field level should be undertaken by trust representatives and the task team as early as possible in the trust's life with the Trust Administration Manual recording the details.

*Distribution of Income Plan.* The trustee will authorize disbursements to the beneficiaries (conservation area, programs, institutions) as stipulated in the trust deed. In general, for GEF-supported trusts, disbursements will comprise the net income from the invested assets of the trust fund. The income will be generated by:

- interest paid on bonds and bank deposits;
- dividends paid on stocks;
- capital appreciation of bonds and stocks from an increase in market value.

Interest payments and most dividend payments are normally paid out at regular intervals, usually on an annual basis. Therefore, the distribution of income generated in this manner can be easily planned and budgeted. Capital gains are realized when a security is sold, and fluctuations in the market means that selling at a profit is not guaranteed. However, this should not pose a problem for income distribution. Securities can be sold at any time, and the proceeds can be held on deposit. Asset managers have clear strategies by which they decide when to capture capital gains by selling stocks. However, there will be periods of poor stock and bond market performance; and in these periods, capital gains may be more difficult to obtain. In those periods, the need to distribute cash from the investments may lead to the selling of stocks or bonds for a loss and thus reduce available income or erode the corpus of the trust.

**How defined should the disbursement arrangements be?** The frequency (eg bi-annual, annual) must be known for the asset manager to build a strategy. Most asset managers do not recommend disbursements more often that quarterly. The rigidity of disbursement requirements affects the risk strategy (see Chapter 7, *Devising Risk Strategies*, page 54). A balance must be struck between keeping the periodicity of disbursements amounts flexible enough to bend

**Disbursements from Uganda's MBIFCT**

MBIFCT will establish a foreign exchange account at a bank in the nation's capital. This account will receive quarterly transfers of the income earned from the off-shore account in the previous quarter or half year. The governing body of MBIFCT will allocate the income based on approved budgets covering the administrative cost of operating the trust and projects approved for MBIFCT funding. The selection of the local bank was based on the availability of branch banks outside of the nation's capital. The trustee will:

- Authorize payments based on specific budgets and implementation schedules;
- Ensure that expenditures are incurred only for approved project budget items;
- Ensure correct procurement procedures are followed which are consistent with World Bank requirements.

to market conditions without adding risk to the portfolio's performance, while being consistent and dependable enough to meet the needs of conservation activities and to build long-term confidence in the trust fund mechanisms.

When establishing an income distribution schedule, the parameters to consider include:

- how often are funds needed to meet major expenses approved by the board?
- what are the domestic (including local level) banking facilities?
- will funds that are sent to the domestic accounts earn interest?
- what are the options for disbursement in periods of lower than target or negative growth?
- what are the consequences (financial, political, legal) of invading the corpus of the trust fund?
- what might be the consequences for fulfilling the trust objectives if disbursements are delayed or missed?

**What happens in a lower than anticipated or negative return year?** There will be years during which the net returns to the investment fall short of expectations. The board of directors and/or trust adviser should work with the asset manager to establish strategies for such situations early in the life of the trust for recording in the by-laws.

If needs exceed net income available, various strategies might be considered:

- Activities eligible for funding could be prioritized with a view to postponing or restricting lowest priorities in order to fit within available net income.

- Funds might be raised from bilateral or other sources to cover any financing gap.

- A small portion of the annual return (i.e. 0.5%) or earnings in excess of the targeted return can be set aside annually to act as insurance for negative return years. These funds would be reinvested with the corpus and only "set aside" in accounting terms.

- The corpus could be invaded, withdrawing the amount required to meet disbursement needs. This solution could whittle away the corpus overtime if there are a few negative years in a short time span or if the disbursement needs are large in comparison to the shrinking corpus. The corpus will remain below it's original level until interest earned on the assets exceeds income and expenditure needs, and can "top up" the corpus.

### Spending Rules

The amount to be spent on financing the trust's administrative costs, conservation activities and institutions can be determined by a "spending rule" designed to provide a sustainable and predictable stream of income over time. A conservative rule, tied to a moving average of the value of the fund, will smooth out variations in total return caused by market volatility, and ensure a steady level of available income to cover the aforementioned costs.

For example, a spending rule might be that only five percent of the three year moving average of the value of the investment portfolio would be available for disbursement in any given year. Given that a moving average is based on the lagged values of actual portfolio size, expenditures for the first three years might be set at a conservative rate of five percent of the current value of the portfolio. Subsequently, the spending rule based on a moving average would be applied.

Definition of a moving average spending rule not only gives the asset manager information critical to investment management, but also helps dampen the effect of low return years, minimizing the need to resort to alternative strategies.

- A high risk strategy would be to take a commercial loan to make the disbursement, using the corpus as collateral. Interest charges tend to be 1% above prevailing interest rates and such loans are usually not taken for amounts less than US$ 1 million. Furthermore, this strategy invades the corpus. The corpus is held as collateral, and may be called to cover the loan and due interest.

*Trust Administration Unit.* This unit can handle day-to-day operation of the trust when the board is not in session and ensure a number of administrative and secretariat functions for the trustee and or/board. The unit might be staffed with an administrator, one or more accountants, liaison/ administrative staff and support staff. Among its duties could be:

- acting as central focal point to receive proposals for funding, reviewing them for consistency and passing them on to the appropriate review groups.
- disbursing funds to beneficiaries
- community relations
- providing information to local level groups
- preparing proposals
- preparing the annual administrative budget
- maintain local accounts and records and
- present the periodic financial and management reports to the board
- monitoring and evaluating funded activities, including the use of funds, implementation and impact of activities

*Asset Manager.* The asset manager is responsible for investing the trust fund assets in accordance with guidance provided by the trustee or board of directors. The asset manager can also be the trustee of an offshore trust, or a co-trustee in a two-tier trust arrangement (see Chapter 6, *Turning to the Private Sector to Establish the Trust Vehicle*, page 49). The asset manager can be domestic or offshore, and is usually an international banking group or commercial investment firm. The asset manager is expected to report to the board on a regular basis, and must be accessible to meet with the board at least once a year (initially, twice a year is recommended) to review investment strategy and performance. The asset manager will receive instruction from the board of directors on risk, return, disbursement and currency requirements.

*Asset Management Agreement.* This contract between the trust (board) and asset manager will set out the basic understandings on:

- authority of the asset manager
  - can take all investment decisions
  - can purchase, sell, exchange, convert assets
  - can place orders with brokers, dealers, agents or issuers
- the practices of the asset manager in carry ing out transactions
  - best execution" principle
  - respects all rules and regulations of the markets in which transacting
- portfolio mix
- confidentiality
- liability insurance
- fees and charges
- governing law

*Trust Adviser.* There are several tasks related to asset management which the board of directors needs to ensure are performed on a regular basis:

- to provide specific advice on any changes in the investment strategy;
- to verify that disbursements are sent and received;
- to communicate critical information to the asset manager such as:
  - specific income requirements;
  - specific details about disbursements;
  - advise if additional funds will be added to the assets;
  - any change in the general investment requirement of the trust fund;
- to audit performance to ensure that:
  - the asset manager continues to follow the agreed upon strategy;
  - the returns are competitive with relevant market indicators or other similar funds;
  - that required reporting is completed for the board of trustees or executive committee.

These responsibilities can be undertaken by either the board of directors, a trust adviser (permanent role with terms of reference and powers specified in the trust deed), an advisory committee, or an independent financial professional brought in on an "as needed basis". The overriding concern is that this role be undertaken

## Introduction

Each trust is a custom made agreement between a settlor (the "owner" of the funds) and a trustee tailored to its legal setting and the needs of the trust beneficiary(ies). There are numerous factors to be taken into account in establishing a trust fund and defining the modalities which will make it work on a day-to-day basis. Some of the important design factors which constrain the location of the trust fund and its assets, as well as how the trust will operate are discussed below.

## Important Design Considerations

The location of the trust or trusts, the location of the trust assets and the structuring of the board of directors will be shaped by numerous factors, among which the most constraining are:

- tax liability of trust assets and income earned;
- risk of attachment from creditors of the client country;
- security of the trust assets
- precautions to prevent frustration of the objectives of the trust.

To date, no ideal solution has been found to create a fully tax free trust, with no risk of attachment, full security of assets, and a guarantee that the objectives will not be frustrated. Trade-offs must be made in such a way that the most critical needs are met and risk is manageable.

This section outlines the four issues in turn and analyzes how existing trusts have forged compromises and found solutions.

### *Taxation*

In many locations, a trust fund may face taxation of two types: first, on the local entity which receives the income and distributes it, and second, on the investment account. Taxation poses two potential problems for the trust fund: net yields to the trust fund will be reduced, and losses on the proceeds of trust fund assets through taxation may notbe acceptable to donors.

Securing a tax-free status depends both upon the legal status of the trust fund entity and its location.

- A tax-free status for the local entity which receives income and distributes it for the project may be accomplished by using existing national regulations for charitable organizations and foundations or by decree of law. Legal counsel, obtained locally, should be sought on this issue as early as possible.
- Tax exemption for the investment vehicle may be achieved through a few different means, all of which may affect the choice of the legal status and location of the trust fund vehicle. Four common options are as follows:
  - Ensure that the local entity has charitable legal status. This can be accomplished by using existing laws and regulations for charitable trusts or foundations, or by decree of law.
  - Trusts can be housed in a tax haven country, for example in the Channel Islands, the Grand Cayman Islands, or the Netherlands Antilles Islands. In these tax havens, the investments of irrevocable trusts are free from capital gains taxes, other forms of income taxes, and most have no or insignificant other taxes. However, each tax haven has particular limitations and advantages which must be explored with the assistance of legal and financial counsel, as a complete discussion of these is beyond the scope of this paper. A major drawback if other donor contributions are to be sought, could be that funds held in these areas have acquired a negative image of avoiding fiscal and regulatory responsibilities. Revocable trusts are usually tax exempt if the primary tax status is non-taxable, which would be the case for conservation trust funds.
  - In some countries, like the US, the investment income of a foreign government is tax exempt. A trust fund, if characterized sufficiently as government funds, can apply for tax exemption (e.g. under the U.S. Internal Revenue Code, Section 892). This requires a ruling and has implications for the level of government involvement in the trust operations.

- Trusts can be established under the auspices of an international organization, such as UNDP, and therefore benefit from its tax-exempt status.

Regardless of these options, some investments may still be liable to payment of withholding tax. For example, the US charges a withholding tax on stock dividends and on the interest payments from some bonds as these might be paid to the trust. There are, however, ways of legally avoiding most of these taxes in tax haven accounts: again, legal and financial counsel should be sought on individual cases as the many possibilities are beyond the scope of this paper.

### *Risk of Attachment*

The risk of attachment arises if creditors of an insolvent government attempt to recover unpaid debt. If a law suit is successful, the court will seek to attach any vulnerable assets of that country to pay back the owners of the debt. While there is some risk that conservation trust funds established off-shore may be exposed to being attached, to our knowledge, no conservation trust funds have been successfully attached by creditors to date.

There is a continuum of risk associated with minimizing taxes and averting attachment, and tradeoffs must be weighed carefully. For instance, a trust whose income is recognized as income of a foreign government for the purpose of US tax exemption, may find those assets more susceptible to attachment as they are already recognized as belonging to the indebted government. To escape both the tax and attachment constraints, the trust can be fully housed within the recipient country with its assets invested in the same manner as those of the government. However, options for asset management will be greatly diminished under such an arrangement, and performance of the investments may be less predictable in the long-term. The Peruvian Trust Fund, FONANPE, has adopted this strategy.

For offshore trusts, the degree of risk seems to depend partly on who donated the funds for the trust, how the trust is characterized, and what happens to funds upon termination or dissolution of the trust. Along the risk continuum the risk seems greatest if the funds are:

- invested off-shore,
- partially funded or commingled with funds granted by the recipient government
- granted first to the government and then passed on to the trust fund,
- heavily characterized as belonging to a government organization.

Furthermore, these attributes will affect the risk levels of the various legal trust vehicles in different ways. Legal counsel to advise on the risk of attachment is necessary for any trust fund that will be established off-shore.

**Box 5.1 Examples of Trust Funds and their Taxation Situation**

| Country and Trust Fund | Location and Status Vis-a-Vis Taxation |
|---|---|
| Mgahinga and Bwindi Impenetrable Forest Conservation Trust (MBIFCT) | MBIFCT will be established as an independent, tax-exempt entity under Ugandan law. The assets will be held offshore in a tax haven. |
| Fiduciary Account for the National System of Protected Areas (CF/SNAP) | The account is housed within FONAMA, a Government tax-exempt umbrella fund, created by presidential decree. The assets would be managed in the US and may qualify as tax exampt investments of a foreign government (should there be a favorable US 892 ruling). |
| Bhutan's Trust Fund for Nature (BTF) | BTF was established as a tax exempt entity under the auspices of UNDP; UNDP is also the asset manager and affords the trust tax exempt investment income. |

Box 5.2 summarizes examples of factors which generally increase or decrease the risk of attachment.

**Box 5.2 Trust Fund Characteristics and Risk**

| DECREASES RISK OF ATTACHMENT | INCREASES RISK OF ATTACHMENT |
|---|---|
| The assets are invested locally. | The trust fund is established under a governmental body or organization and funds are off-shore. |
| Trust fund is supported 100% by non-(recipient) government sources | The trust fund is partially funded or commingled with funds contributed by the recipient nation. |
| The recipient government is removed from any control over the assets. | Government representatives have an active role in the board of directors and can influence decisions by forming voting blocks. |
| The change of ownership of the disbursed income occurs in the recipient country, not at the site of the off-shore trust fund. | The GEF grant goes to the government first for subsequent transfer to the trust fund. |
| Trust fund is irrevocable, or revocable to an NGO or the GEF. | Funds are revocable to the government. |
| Trust is established in the country in which trust funds are, by law, not vulnerable to attachment as long as basic non-fraudulent criteria are met. (e.g. Switzerland). | Fund established as a tax free fund in the US (or any other country) under the IRS 892 ruling (or appropriate rules) as investments of a foreign government. |

## Security of Assets

The financial assets of the trust fund must be maintained:

- safe from risk of misappropriation and inappropriate investments,
- secure from rapid erosion in real value due to high or hyper inflation,
- free from liquidity worries, and
- in a safe location.

*Appropriate investment of assets.* The first area of concern is that the assets are managed by a qualified asset manager. Chapter 7, *Selection Criteria for Asset Managers*, page 55, sets out criteria for selecting an asset manager, while *What is Total Real Return?* and *Devising Risk Strategies*, provide guidance on establishing an investment strategy. The selection of a qualified, experienced and reliable asset manager is a critical step in the establishment of a trust fund, and due attention should be given to this process.

A related concern is that the funds will be invested in a way which best responds to the objectives of the trust fund. This can be done by ensuring that:

- The fund manager clearly understands the objectives of the trust fund;
- The board of directors receives regular reports which determine whether the agreed investment strategy is being implemented;
- Situations giving rise to obligatory consultation are specified for the asset manager. For example, the asset manager would agree to advise the board of directors or trust manager if the asset allocation of the investments needs to be changed beyond a previously agreed range (e.g. 5-10%).

*Protection from risk of inflation.* This concerns primarily those trust funds which maintain a proportion of their assets in local currency. Although interest rates on local deposits may be attractive in nominal terms, often above 20%, real returns could easily be negative if those rates are not adjusted regularly in line with inflation or devaluation is imminent. These risks must be counterbalanced against the benefits of maintaining a local account, in particular for a heavily indebted nation, and diminished risk of attachment. See Annex 3 for references concerning local currency trust funds.

*Liquidity.* Liquidity refers to the readiness of the funds to be withdrawn from the account. For example, if an account is fully invested in stocks and bonds, and a cash disbursement is urgently needed, the asset manager must sell some of the stocks or bonds to generate cash. In OECD markets this poses no problems; a cash transfer can usually be made within two working days of the request. However, in some smaller stock and bond markets, a sell for cash cannot be made as quickly due to local regulations or lack of a buyer in the market. (A further complication of mutual funds is that some are only traded a few times each month.) Most asset managers will recommend setting aside a small percentage of funds in cash deposits to meet emergencies and to take advantage of a change in market conditions.

*Safety of the physical assets.* The location of the trust vehicle and that of the physical assets may not be identical. Most international banks hold their assets in OECD countries and are generally considered 'safe'. However, some tax haven locations may require that the funds be held in a small country which, in the worst case scenario, may become politically insecure. For this reason, most large institutions which operate in these locations have "flee clauses", meaning the funds are automatically transferred to another location should the situation become jeopardized. This detail should be examined before an account is opened in a potentially vulnerable country.

## Ensuring Trust Objectives Will be Met

Due to the long term nature of trust funds, there is justified concern that in future years management may go awry and funds used for other than their intended purposes. These concerns can be reduced by incorporating various checks and balances in the trust fund design. This section outlines how checks and balances can be introduced in legal instruments, in structures or through the mechanisms listed below:

- the legal instruments of the trust
- the board of directors,
- a revocability clause,
- external monitoring and evaluation,
- detailed provisions on accounting and reporting and auditing.

No model for the formulation of controls is proposed here. Rather, legal expertise should be engaged as early as possible to advise on this aspect of trust fund design.

*Legal documents establishing the trust.* The trust deed states the objectives of the trust and the scope of activities which it may undertake. A precisely defined trust objective and scope of activities:

- focuses the direction of the board of trustees, and

**Box 5.3 GEF Trust Funds and Strategies to Ensure Security of Assets**

| TRUST FUND | LOCATION AND STATUS VIS-A-VIS SECURITY OF ASSETS |
|---|---|
| MBIFCT, Uganda | Assets will be managed in hard currencies in an off-shore account to avoid inflation and to ensure top professional management. |
| CF/SNAP, Bolivia | Assets will be managed in US dollars by professional asset managers in the US. |
| FONANPE, Peru | Assets will be managed by a domestic asset manager in Peru. Modalities to be determined. |
| BTF, Bhutan | Assets are invested by UNDP in short term deposits and government bonds, as per UNDP's investment regulations. (See Chapter 4, *Minimum Viable Size of a Trust Fund*, page 24). |

- clarifies the specific goals by which activities to be financed by the trust fund can be evaluated, and selected.

The legal documents should clarify if the trust fund can accept earmarked funds from donors for certain projects which may deviate from the original scope of activities. If it can, the trust deed should explicitly state that the focus of the trust fund cannot be changed by such additional funds. Criteria and limitations for accepting earmarked funds should be considered, for example setting an upper limit on the percentage of total assets that earmarked assets may represent in the trust fund.

*Structure of the board of directors:*

- Who is represented on the board?
- How are they replaced?

GEF supported trust funds are characterized by a broad representation of stakeholders on the board of directors. To maintain this principle and avoid any one interest group gaining control over the trust's activities, the by-laws should spell out how members are to be replaced over time. (See Chapter 4 Designing the Trust, *Components-Putting the Parts Together*, page 27, concerning boards of directors.)

*Revocability clause.* Subject to the issues raised in Chapter 3, *Distinct Rules for Public or Charitable Trusts, Revocability*, page 17, a clause may be added allowing the trustee to revoke the trust. A revocability clause sets the terms under which a trust can be terminated and its assets redirected, transferred or distributed, including return of funds to the donors. Depending upon local law and the intent of the founder of the trust, this clause could be triggered by:

- a vote of the board of directors;
- the trustee;
- consent of the settlor and all beneficiaries; or
- a third party.

An irrevocable fund, as the name implies, excludes the possibility of reverting the funds to the donors. However, the board of directors or a third party may be granted the power to effectively freeze or dissolve an irrevocable trust fund and transfer the monies to another project or trust with compatible objectives. (See Chapter 3, *Modification and Termination*, page 19, on trust termination).

*External monitoring and evaluation.* Periodic in-depth review by donors also provides an opportunity to check the effectiveness of trust fund operation. The consequences of a less than satisfactory review should be included in the trust deed, and might include the delay of fresh capital being transferred to the trust fund. These reviews could be planned for one year into operation, two years into operation or as appropriate, and include a check on some or all of the following points:

- asset management performance vis-a-vis the original financial objective;
- adequacy of sub-project selection criteria and application, including impact of activities financed;
- amounts disbursed at field (conservation area) level;
- representativeness of individuals serving the board of directors and committees.

*Financial reporting and auditing.* Detailed provisions should be incorporated in the trust deed on accounting, reporting and auditing. It is recommended for audits that:

- the trust engage an independent auditor;
- the local trust be audited annually, and if deemed necessary, audited after the first six months of operation;
- the offshore trust, if different from the asset manager, also be audited annually;
- the asset manager make a report to the board of directors every 6 months for the first two years, and annually thereafter.

| Box 5.4 Design Features to Ensure Trust Objectives Will Not Be Frustrated | |
|---|---|
| | **Trust Fund Design Features** |
| MBIFCT, Uganda | The World Bank will approve the board of directors' initial membership. The procedures for replacing members are contained in the Trust Deed and By-Laws. The Trust Deed and By-Laws cannot be modified without the World Bank's consent for the first five years. After that, a unanimous vote of the board is required. Independent audits will be held every six months during the first year, and annually thereafter. The structure of the Board of Directors balances interest groups and voting systems ensure no one party has control of the board. |
| CF/SNAP, Bolivia (The fund is one of several accounts under FONAMA, an umbrella fund) | FONAMA and a commercial bank in the U.S. will be co-trustees of the trust fund. All decisions taken by the board of the domestic trust will be channelled through FONAMA to the co-trustee which also houses the trust account. |
| BTF, Bhutan | The voting strategy and membership composition of the board of directors guard against conflict of interest. The board comprises three government representatives, one from WWF, and one from UNDP. A majority vote of 4/5ths is required for all decisions. |

# 6 Diversity of Instruments

This chapter outlines the possible combinations of trust vehicles and asset management arrangements which can be utilized for trust funds. The second section profiles the trust fund instruments which are available. The chapter ends with a look at employing the private sector to establish and manage trust funds.

## Summary of Main Points

- The three major categories of locations for trust fund vehicles are:
  - Domestic trusts with domestic or off-shore asset management accounts;
  - Off-shore trusts with off-shore asset management in OECD Countries and tax havens;
  - Trusts based in multilateral aid agencies with asset management either by or outside the agency.
- Domestic trusts can have their assets managed off-shore in one of two ways. The simplest is to establish an asset management account in an OECD country or tax haven. The second option is a two-tier system which pairs an off-shore trust which holds the assets with the domestic counterpart.
- Considerations when opting for a commercial bank managed asset account over a trust vehicle are indemnification, fees, and the bank's right to terminate the agreement.
- Trust funds can be designed as sinking funds which disburse all assets over a fixed period of time.

## Key questions addressed by this chapter:

- What are some of the key issues involved in deciding the location of a conservation trust fund?
- What are the advantages and disadvantages of establishing a domestic trust fund and domestic asset management?
- What are some of the options of establishing a trust under the auspices of a multilateral agency?
- What are the alternatives for off-shore trusts funds in non tax haven countries?
- What are some of the advantages and disadvantages of establishing a trust fund in a tax haven country?
- How can a commercial bank help establish a trust fund?
- What are the concerns for any commercial bank involved in establishing a trust fund?

## Introduction

As discussed in the preceding chapter, the location of the trust and its assets will depend on a variety of factors. This chapter outlines the criteria and issues involved in determining the best location for the trust and the trust assets. The three options for location are:

- Domestic trust with domestic or off-shore asset management account
- Off-shore trust with off-shore asset management based in:
  - OECD Countries
  - Tax Havens
- Trusts based in multilateral agencies with asset management either by the agency or by an outside asset manager (i.e commercial bank)

## Domestic Trusts

There are five basic questions which will help establish if a domestic trust (charitable or with tax-free status) should be established:

- Is there an established body of law regulating trust funds or charitable foundations?
- What are the specific legal requirements of establishing a trust fund?
- If there is no legal structure, what is required to establish a trust fund by governmental decree?
- Is it desirable to use an appropriate "umbrella" body or fund which already exists to house this new trust?
- Are there regulations concerning off-shore asset management?

There are often strong arguments for and against housing the trust fund locally.

**Decision Chart for Trust Fund Location**

This box provides useful questions for determining trust location. Very few cases will have a clear outcome; the majority of cases will fall in between a wholly domestic or wholly off-shore solution. In those cases, a domestic trust fund with an offshore asset management account or a two-tier system may result in a workable compromise.

Is there:
- a rationale for housing the trust in the country?
- a legal setting for trust funds or trust-like arrangements?
- only one country which will benefit from the trust fund?
- the possibility of investing funds onshore?

all yes-> local trust fund
all no-> off shore trust fund

Alternatives for ambiguous cases

If the answers are mixed, determine to what extent the non-priority concerns can be met by creative solutions and compromises. Multiple options should be examined before advancing into the design and structuring of a trust.

- absence of a clear rationale — establish a two-tier trust system or establish a trust under the auspices of an international agency
- absence of a legal setting — create a trust vehicle by decree of law
- more than one country to benefit from the trust fund — establish a two-tier trust system or a trust under the auspices of an international agency
- no or uncertain possibility of investing funds off-shore — seek exemption to invest funds off-shore

*Advantages of a domestic trust:*

- it will function under the laws of the country whose beneficiaries it serves;
- the benefits of capacity building in trust management accrue to the country and, if assets are also held domestically, financial management capacity can also be strengthened.
- the perception of national "ownership" could create greater awareness of and commitment to environmental issues;

*Disadvantages of a domestic trust:*

- a domestic trust might suffer from the perception that the funds belong to the government and are therefore fungible;
- the risk of political instability may endanger the objectives of the trust and, if assets are held domestically, the safety of the assets;
- some donors may be hesitant to contribute given their perceptions of the above cited risks;
- there may be restrictions on non-profit foundations contributing to such Trust Funds. For example, some US charitable organizations may require recipient organizations to have a certain legal status that a locally based trust would not meet.

## *Domestic Asset Management*

As noted in Chapter 5, *Taxation*, page 36, and *Risk of Attachment*, page 37, issues such as attachment and tax liability may warrant creation of a domestic trust with domestic asset management. This option should be considered when the host country is heavily indebted and there is sufficient linkage between the assets and the host government for the assets to be deemed liable to attachment. One option is to invest the funds in the same safe jurisdiction in which the government invests its funds. This arrangement keeps the assets free from attachment and taxation concerns.

However, the domestic asset management option should only be considered when there is sufficient in-country competence for an asset manager to be identified on the basis of the criteria given in Chapter 7, *Selection Criteria for Asset Managers*, page 55. Special expertise is required to invest the funds in domestic capital markets which may be vulnerable to liquidity problems and high volatility. An alternative in such a case is to grant the board of directors power to invest the funds in the same jurisdiction as government funds, but to ensure there are guidelines and conditions on how the funds are to be invested. This, however, limits investment flexibility and may not provide optimal investment returns under changing market conditions.

If domestic management of assets is strongly desired in the long run, a compromise might entail an initial offshore asset management, with a clause in the trust deed to reassess the possibility of moving the asset management on-shore at the mid-term review or other appropriate time.

## *Offshore Asset Management*

The advantages of offshore professional asset management are many; namely, the assets can be invested in a hard currency, in a secure market, in a secure location, and in an account which is tailored to the objectives of the trust fund. Chapter 7 discusses issues of asset management.

There are two mechanisms for offshore asset management. The simplest is a straightforward asset management account, opened in an OECD country or a tax haven. Most simple asset management accounts in OECD countries will be liable to pay some tax on income earned; accounts in tax havens such as the Channel Islands may therefore be more attractive. For example, an asset management agreement can be settled with an international bank in London for an account held in the bank's Channel Island subsidiary. If this method is unsuitable due to concerns of attachment, tax implications for the domestic trust, or concerns of irrevocability of the assets, a two tier system might be more appropriate. In a two-tier system, the domestic trust is a tax-exempt entity and is the sole beneficiary of the offshore trust. The offshore trust acts as the investment account and should also be tax exempt.

## Charitable Trusts Established By a Multilateral Aid Agency

Trust funds can be established under the auspices of a multilateral aid agency. For example, the Bhutan Trust Fund for Environmental Conservation is established under the auspices of UNDP. This affords the trust fund tax exemption, protection from attachment, and security of assets as the trust benefits from UNDPs legal status covering these issues. The drawbacks to such arrangements may include an external layer of administration and the continued involvement of and assumption of responsibilities by the multilateral aid agency. For certain donors, this solution may afford the advantages of locating the trust funds in a tax haven without the negative perception sometimes associated with the latter.

The fund assets can also be managed by the multilateral aid agencies (which is also the case for the Bhutan trust fund). However, if high returns are an objective, the agencies' conservative investment practices and fee arrangements may not make this an appropriate solution (see Chapter 4, *Minimum Viable Size for a Trust Fund*, page 24). An alternative to explore is whether the funds of a trust established under the auspices of a multilateral aid agency can be invested with an outside asset manager.

## Charitable Trusts or Foundations Established Offshore

Offshore trust entities may exist either as a single entity trust or as part of a two-tier system. In either case, the choice of establishing the trust offshore and its specific design and structure will reflect the concerns of attachment, taxation, security of assets, and control systems.

A single entity offshore trust might be created when a domestic legal system cannot accommodate a trust arrangement, risk to the trust is considered too high by establishing it in the country of the beneficiaries, or the trust is created to benefit multiple countries. An example of the latter is the tri-national Foundation for East Carpathian Biodiversity Conservation, which was established as a Swiss Foundation in Geneva. To date, no single country GEF supported trust fund has been established offshore for the first two reasons cited above.

There are two approaches to selecting an offshore location for a charitable trust:

- Sometimes the location will be chosen due to the relationship between the involved countries. For example, are there established partnerships for the environment? Is geographic proximity important? Are there political preferences?
- Sometimes the legal frameworks and options of the country where the trust will be established will be the critical factor. There are some countries which have trust or foundation laws and traditions which suit the needs of the project or special requirements of donors.

**A Swiss Option to Trust Funds: Swiss Charitable Foundations**

Switzerland is the home of many international charitable trust funds. Its political neutrality, accessibility within Europe, and strong laws regulating foundations have made it a choice location.

In Switzerland, regulations governing foundations vary from canton to canton [state to state]. Usually, the president of the board must be a Swiss citizen. Swiss law firms or private individuals can usually perform these services, however there is often a fee. Some cantons dictate that the board of directors meets in Switzerland.

One disadvantage is that all Swiss bank accounts are levied with a federal stamp tax on every security transaction. The Federal stamp tax is 0.15%. Some cantons also levy a tax (eg Geneva levies a 0.015% tax).

## A Few Options for Trusts in OECD Countries

The following section provides an outline of some of the options available in non-tax haven OECD countries to establish tax exempt trusts or foundations. It is meant to be indicative and not exhaustive. The legal, operational, and administrative requirements of each jurisdiction vary and therefore dictate engaging legal counsel to carry out a comprehensive examination of a variety of options before the selection is made.

### *Charitable Trusts*

Most countries have mechanisms to grant charitable organizations special tax status. Charitable conservation trust funds can be set up in three different ways:

- as an autonomous charitable organization;
- with an international NGO negotiating the establishment of the trust and transferring the assets to it (i.e. acting as "settlor" of the trust); or
- under a restricted account of an existing charitable organization.

*Establishing a charitable trust.* Each country has its own regulations for establishing charitable organizations but, in general, any such organization must be able to prove that it operates exclusively for charitable purposes and is not merely a conduit for foreign funds. Some countries do not permit foreign organizations whose activities are solely foreign to qualify for charitable status. Most countries have some administrative requirements such as the filing of annual reports, and will levy penalty taxes if those requirements are not met.

In some countries there is no legal basis on which to establish trust funds. For example, civil law countries usually do not recognize trust funds. However, charitable foundations in these countries may serve as a viable alternative. Switzerland, Austria, and Liechtenstein are three countries which have a history of housing both charitable and private foundations. Foundations can be set up in similar ways to trust funds and often can meet the exact needs. Legal advice must be sought concerning a particular jurisdiction's regulations.

In the US, a charitable organization can be granted special tax status, if it meets certain operating rules, under section 501(c)(3) of the Internal Revenue Code. The most significant rule for the charitable organization is that it pay out not less than 5% of the fair market value of the trust's assets annually. In years during which the trust's investments earn less than 5%, disbursements must be made from the corpus (i.e. the capital) of the funds. An excise tax of 1% or 2% is levied annually on net annual investment income.

In Singapore, Section 13 of the Income Tax Act exempts charitable institutions from income tax. The trust would be established by a trust deed which specifies the donors, the trustees, and the purpose of the trust.

In the Netherlands, a tax-exempt charitable foundation can be established if it can prove that it does not engage in activities which are in competition with Dutch companies. A foundation may participate in business activities, and the support of "eco-ventures" should not be incompatible with a Dutch foundation. Furthermore, due to the numerous tax treaties in place in the Netherlands, the investments of the charitable trust may be subject to significantly lower withholding taxes on investment than other trusts established elsewhere. The only other requirement is that a Dutch citizen sit on the board of directors, a task which a Dutch commercial bank can perform. It should be noted that some financial institutions charge a V.A.T. (17.5%).

### *NGO as Settlor*

An alternative to establishing a charitable trust with a recipient government as settlor, is to engage an international NGO to take this role. When an NGO acts as a settlor, a new trust entity is created. The grant could be made directly to a tax-exempt NGO which would in turn transfer the assets and complete any necessary legal agreements to establish the trust fund.

### *Using a Restricted Account*

A third alternative for using a charitable trust structure would be to establish the fund as a "restricted account" of an existing charity or NGO. No new trust entity is created. This would entail:

- finding a charity or NGO whose activities are completely compatible with the purposes and activities of the GEF and the trust;
- appraisal of the charity or NGO; and
- negotiation of a satisfactory agreement for trust management.

The agreement with that charity would be structured to reply to the objectives and concerns of the GEF and World Bank, the charity and or NGO, a situation likely to result in the loss of strong national ownership of the trust fund.

### *Foreign Government Tax Exempted Accounts*

Some countries provide tax exemption for the investment income of foreign governments. For example, investment income generated for foreign governments in the U.S. is tax exempt under section 892 of the Internal Revenue Code. This alternative has two major drawbacks. First, it requires that the Trust Fund be very closely linked to the government, by which the independence of the trust fund might be threatened. Secondly, by identifying the funds as governmental, they become vulnerable to attachment if the country has creditors.

## U.S. Grantor's Trust (or Substantial Owner's Trust)

Under this option, the World Bank would act as settlor for a GEF grant being transferred directly to a trust fund. The trust would be structured so that two or more of the following conditions are met:

- It is not an irrevocable trust.
- The income may be withheld from the beneficiary if deemed appropriate by the grantor.
- The trust may be directed to other ends or the assets reverted to the grantor should the objectives be frustrated.
- The grantor can change or recess beneficiaries.

Grantor's trusts may file for tax exemption under the rules governing the settlor. While this would imply that the Bank's special tax status could be passed on to the trust fund and that there would be almost no risk of attachment there would be a loss of "ownership" by the client country. The Bank would also take on various obligations in perpetuity: such an option has not yet been put to Bank management.

## A Few Options in Tax Havens Locations

The second type of off-shore account is one that is granted special tax treatment due to its location. Locations which offer special tax treatment to accounts which are based there include the Grand Cayman Islands, the Bahamas, and the Netherlands Antilles. Each location has its own particular tax situation and regulations; and rules and regulations will vary locale to locale. However an account placed in one of these locations usually enjoys a virtually tax free status. Most large international banks, and many smaller specialized banks, have developed expertise in these types of accounts and usually are represented in these locations.

The **advantages** of domiciling the account in a tax haven include:

- an easily obtainable tax free status (or virtually tax free);
- accessibility of top professional asset managers;
- wide selection of investment opportunities in bond markets which avoid withholding taxes;
- possibilities to invest in equity markets in a withholding tax free condition;
- security of assets in locations which offer a "flee clause" to automatically transfer the assets to another location should the location become vulnerable.

The **disadvantages** of tax haven trust funds are centered around issues of perception and include:

- Some recipients and donor nations may be sensitive to the image that tax havens are used to avoid fiscal and regulatory responsibility. This perception is particularly acute for Caribbean based tax havens.
- Fees for establishing a trust fund in these locations can be higher than for accounts domiciled in the US or UK. This is a rough generalization, and exceptions are easily found. Furthermore, the savings in taxes may easily justify a slightly higher management fee.

## Turning to the Private Sector to Establish the Trust Vehicle

Many commercial banks and trust companies can add value to the process of establishing a conservation trust or a foundation, bringing years of highly specialized trust experience gained from servicing other non-profit groups who have similar income distribution and tax-exemption requirements as conservation trust funds. For legal counsel, the commercial bank will usually introduce the client to a specialized trust lawyer with whom they often work.

Setting up trust funds and foundations is a profitable venture for commercial banks. Most international investment banks have departments which specialize in trust management, both for trusts established in their home country and for trusts in tax haven locations. The incentive for these firms to undertake trust management is that they would become the asset manager for the trust, an activity which usually generates substantial revenues for the firm. Asset management fees are usually levied in addition to fees for the trust management. Banks charge a fee to manage assets, and they also benefit from economies of scale in trading securities and using that capital as collateral. A common strategy for banks is to charge low annual fees to establish and maintain the trust (i.e. 0.10% of the asset value), to provide a package of legal and accountancy services to help the client, and to manage the assets. The benefit to the client is that a comprehensive service is usually advantageously priced and negotiations are easier if the

**Asset Management in Tax Havens: A Few Facts**

**Minimum size:**
Each bank has minimum account size requirements. Due to the fee structure, accounts under US$ 1 million are usually not viable. Fees are usually calculated as a percentage of assets, and for asset management services start around 1%.

**Taxation:**
Many of the tax havens have no income or capital gains taxes at all, however other taxes may be levied, for example:

- On the Isle of Man and Netherlands Antilles, there is a potential chargeable V.A.T. on services;
- On the Grand Cayman Island, there is a one time stamp tax of US$ 40.00.

**Withholding Tax:**
Accounts or some portion thereof are sometimes liable for withholding tax depending on how their funds are invested. This is dictated by the withholding tax laws of the source country. For example:

- There is withholding tax on US Domestic Bonds issued before 1984 and on all US Stocks traded in the US;
- Bonds purchased in the Eurobond market (including US bonds) are not subject to withholding tax;
- Equities, including US equities, which are part of a mutual fund based off-shore are not liable for U.S. withholding tax.
- possibilities to invest in equity markets in a withholding tax free condition;
- security of assets in locations which offer a "flee clause" to automatically transfer the assets to another location should the location become vulnerable.

**Box 6.1 Example of a Domestic Trust with Offshore Asset Management Account**

Uganda's MBIFCT is a domestic tax exempt trust with no restrictions on holding assets off-shore. The board of directors chose an international asset manager in the U.K. who will manage the assets from London. To avoid U.K. income taxes on the trust's assets, the account will actually be held in the bank's Channel Island branch.

same banking group manages the offshore trust and financial assets.

The basic steps for engaging a bank as a trustee are:

- Create the non-profit corporation or charitable trust entity which will have certain powers over the assets.
- Select the board of directors.
- Elect the officers of the board.
- The bank and board of directors negotiate the terms of the trust deed and contract to establish the bank as trustee.

There are three concerns for the commercial bank with regard to establishing a trust vehicle for clients: indemnification, fees and ability to terminate the agreement

First, most firms will seek indemnification from their clients against the potential legal fees arising out of a law suit. In other words, they need a guarantee that as long as they perform their duties properly, they will not be financially liable if there is a law suit brought against them as trustee or against the trust. Banks might seek indemnification from the World Bank, UNDP or UNEP, because indemnification from the trust itself may not be sufficient.

Second, banks expect to earn fees for their services, be it through the trust fund management or asset management. As mentioned above, the incentive for banks to establish trust funds is to manage the assets. Usually trusts are managed by banks for an annual fee of about 0.10% of assets, plus any extra expenses (eg communications, legal). Asset management fees should be negotiable. Some banks calculate a flat fee based on expected work load related to the trust.

Third, banks need to be able to step away from the agreement and annul their responsibilities at any time. If banks are no longer confident that they can carry out their responsibilities as trustees, they need to terminate the relationship. This is a standard clause in trustee agreements. Banks can also terminate asset management agreements at any time.

**Box 6.2 Offshore Trusts**

| GEF Supported Trust Funds Using Off-shore Trust Arrangements | | |
|---|---|---|
| A Swiss Solution for a Tri-National Fund: Foundation for East Carpathian Biodiversity | *Using a Local Umbrella and Offshore Trust: Bolivia's CF/SNAP* | *Under the Auspices of an International Agency: Bhutan's Trust for the Environment (BTF)* |
| **Prime Concern:**<br>Find a neutral but close location | **Prime Concern:**<br>Use existing umbrella institution in Bolivia (FONAMA) | **Prime Concern:**<br>Establish a tax free status and a location agreeable to donors. |
| **Background:**<br>The Foundation needs a trust outside yet close to the 3 involved countries. | **Background:**<br>Two-tier system with domestic trust under FONAMA and offshore commercial bank serving as co-trustee as well as managing the assets. | **Background:**<br>BTF was established under the auspices of UNDP to assure a safe and tax free vehicle which would permit the assets to be managed outside of Bhutan. The assets are managed by UNDP. |
| **Advantages:**<br>• Switzerland is close by and offers a convenient legal setting for non-profit foundations.<br>• A co-donor to the trust fund has established banking relationships in Switzerland. | **Advantages:**<br>Assets can be managed in a tax-free situation yet the funds remain closely tied to Bolivia and FONAMA | **Advantages:**<br>Although tax haven options were considered, this option was taken to avoid the perception of 'hiding assets'. |
| **Disadvantages:**<br>• There is a tax on all security trades made in Swiss accounts of 0.165%.<br>• A Swiss citizen must serve on the Foundation's board of directors | **Disadvantages:**<br>FONAMA has direct contact with the asset manager; the board of directors does not. Furthermore, the Board is not defined in the Trust Agreement between FONAMA and the Bank. | **Disadvantages:**<br>Due to internal regulations, UNDP has a limited range of investments it can make for the fund's portfolio, and it will be difficult to obtain a wide diversification in the asset mix. |

# 7 Asset Management

This chapter introduces asset management principles and is divided into three sections which focus on: issues of return/volatility, criteria for selection of an asset manager, and other issues on investments.

## Summary of the Main Points

- The investment strategy must be consistent with the trust fund's objectives and guidance provided to the asset manager on risk, return, disbursements (liquidity) and currency.
- Volatility in a portfolio can be reduced by: (1) a longer time horizon and more flexibility in the disbursement schedule since this decreases the risk of being forced to sell securities at a loss and (2) diversification in assets.
- The selection of an asset manager should take into account: (1) investment capability, (2) experience and reputation, and (3) ability to guarantee the safety and stability of the invested assets.
- Fees should not be an over-riding factor in the selection of an asset manager.
- Other investment issues covered are location of an asset manager relative to performance in different financial markets, investing in emerging markets and socially responsible investment.

## Key questions addressed in this chapter:

- What is the risk/volatility relationship of a portfolio and how might it be decreased?
- How does diversification affect volatility?
- What criteria should be used for selecting an asset manager?
- Should fees be a factor in asset manager selection?
- Under what conditions might emerging markets be an investment avenue for trust fund assets?
- What is socially responsible investing?

## What is Investing?

Investing means purchasing securities on a stock exchange with the intention of holding them to earn dividends or selling them later for a profit.

- Buying a **stock** for a trust fund means that the trust fund is a shareholder in that company. The board of directors needs to decide if they will be active or passive shareholders, or perceive any social or ethical responsibility with that role (see *Other Investment Issues*, page 59, on socially and environmentally responsible investments).

- **Bonds, or "fixed income securities"** are the debts of either a government, corporation, or multinational agency which have been packaged and sold on the market to raise money for the issuer. The price of the debt and interest rate will depend on the overall economic climate, but also on the risk that the debtor will default on the loan. A rule of thumb is: the higher the yield over current inflation, the higher the risk. Bonds are usually rated for risk. The two standard rating systems used internationally are Moodys and Standard and Poors. Most conservation trust funds will want only AA or better rated bonds.

- When **deposits** are purchased, the bank with whom they are deposited usually loans the money to other lenders (in simplified terms). Therefore, it is necessary to ensure that the bank does not have a credit risk, or that the deposits are insured federally.

## What is Total Real Return?

Investments grow through interest paid on bonds and bank deposits, dividends paid on stocks and capita gains on bonds and stocks from an increase in market value. These asset classes tend to perform differently.

The gross return of an investment will be reduced by any management fees, adminstrative fees, or taxes which are charged against the account. As outlined in Annex 4, a rough guide to asset management fees suggests that a management fee of 1% plus custodial fees and other expenses of 0.1% is a safe estimate. Furthermore, if the trust fund is to maintain its real value over time, income must be plowed back into the corpus to compensate for inflation. Therefore, when planning an investment strategy, differentiation should be made among gross returns, real returns (inflation adjusted) and real net returns (inflation adjusted minus fees, administrative and tax charges).

For example, if an investment account earns 11% in one year and inflation is 3%, the net real return to the account is likely to be 11% - 3% - 1.1% (management fees) = 6.9 %.

## Devising Risk Strategies

Although there are no inviolable rules for establishing a level of risk in a portfolio, there are two factors which tend to decrease risk: long-term horizons and diversification. Both of these need to be assessed for each trust fund.

*Long-term Horizons.* Timing becomes an important issue when funds must be distributed at regular intervals. Scheduled disbursement might fall at a time when there is a decline or negative growth in the portfolio's value. There may also be periods of high growth when total returns exceed disbursement needs. The more flexible the distribution schedule, the longer the recovery period afforded a portfolio after a period of poor market performance before having to distribute income. (See Chapter 4, "Distribution of Income Plan", page 31, on income distribution plans and disbursements.)

*Diversification.* Moderate diversification within the portfolio is perhaps the most effective tool to decrease volatility. Diversification of assets refers to:

- The classes of asset (stocks, bonds, bank deposits)
- The breadth of investment (moderate international diversification, quality of assets, use of derivative products)

The difference between the classes of assets is outlined at the beginning of this chapter. The breadth refers to the geographic spread, quality differences, and use of spin-off or derivative products. For conservation trust fund portfolios, the latter two are less important because a conservative strategy rules out any lower quality assets[1] and derivative products which tend to be volatile. (N.B. not all derivative products are high risk, but a discussion of these products is beyond the scope of this paper. Any large international asset management group or bank can provide this information.)

Investments in global markets have increased significantly in recent years. The US stock market now represents only 38-40% of the world's capital market. As capital markets grow internationally, the importance of "not putting all your eggs in one basket" increases. A moderate diversification of investments among a few markets has decreased performance volatility and increased performance over a one-market portfolio. The chart on page 56 (Box 7.1) shows that for investors based in the US dollar, for the period of 1960-1992, a portfolio with 70% US investments and 30% foreign investments had the lowest volatility (roughly 7.5%) and slightly higher return (roughly 8.25%) than a portfolio with 100% US investments (which had an 8.25% volatility and 7.0% return). This chart also shows that moving away from diversification leads quickly to higher volatility, and increased returns.

The major source of volatility in internationally diversified portfolios comes from the currency fluctuations. A rule of thumb is that in a global bond portfolio, currency fluctuations make up roughly 50% of the total return. In a global stock portfolio, currency fluctuations make up around 25% of the total return. Therefore, extensive diversification for a very conservative bond portfolio may not be recommended. However, for funds with some equity positions, international diversification should be considered for a small percentage of the assets. Alternatively, the impact of currency fluctuations could be minimized by holding a portion of the fund assets in currency options or tying a portion of the assets to a major currency in use in the country where the trust will operate (US$ for Latin America, FF for francophone West Africa).

The range of acceptable risk and impact of volatility will also in part depend on the objectives of the trust fund and anticipated administrative costs and disbursements for board-approved conservation activities, programs and institutions, and must be clearly spelled out to the asset manager. For example, a trust fund may:

- seek maximum growth with no distribution for the first five years, after which steady income flows are required;
- require absolute secure income distribution for the first five years, after which the disbursements might become more flexible;
- seek maximum growth and have flexible, rolling disbursement schedules.

Different investment strategies are required in the three cases. GEF supported conservation trusts are also likely to have needs which change over time. Therefore the asset manager will periodically require updated information and feedback from the trust management (trustee/board of directors). Once the risk/return and disbursement needs have been established, the asset manager should indicate the asset mix expected to be used in the portfolio. It should be stipulated that either the board or the asset manager can reopen the discussion on investment strategy.

## Selection Criteria for Asset Managers

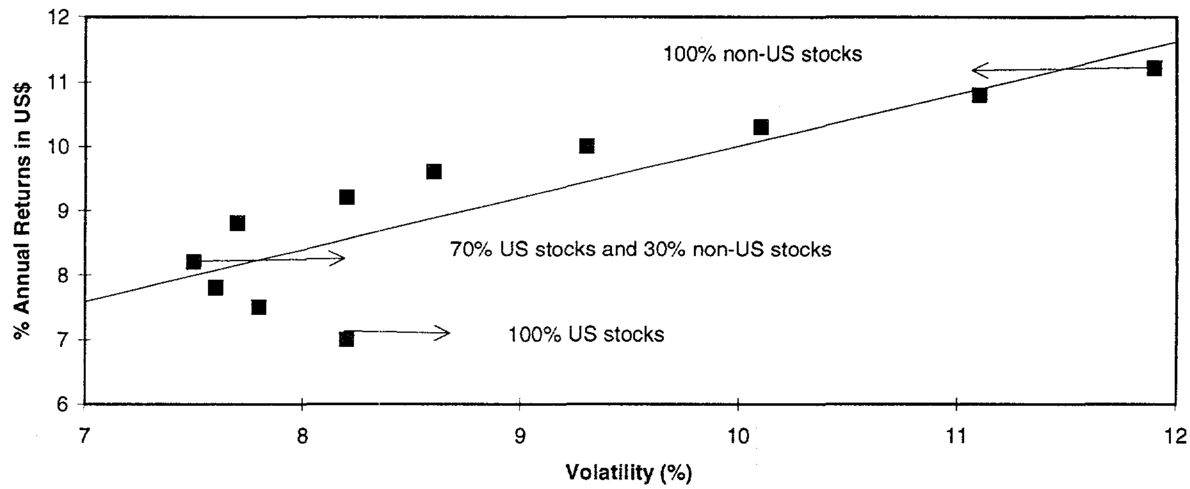
Each trust fund will have a unique set of requirements for asset management. Therefore, it is not possible to set out a matrix of criteria for all trust funds to follow. The criteria need to cover a wide range of factors, including the institution's financial record, asset management performance record, staffing, organization and reporting, investment philosophy, total costs and any other special attributes specific to the needs of the trust fund.

Criteria generally fall into three categories: investment capability, experience and reputation and ability to ensure the safety and stability of assets.

### *Investment Capability*

- **Powers** - The asset manager has the capability and flexibilty to invest so as to reach or exceed established benchmarks
- **Performance Record** - Should be consistently (10 years or more) above or in line with relevant general and specific benchmarks.[2]
- **Capacity** - Has the experience and capacity in construction of balanced protfolios consisting of significant proportions of long-term fixed-income instruments, equities and cash, and has indpendent research and analysis capability.

**Box 7.1 Chart of Diversification, Risk and Return**




| Box 7.2 Examples of Asset Management Arrangements and Investment Strategies | | |
|---|---|---|
| **Trust Fund** | **Asset Management Arrangement** | **Investment Strategy** |
| MBIFCT, Uganda | UK commercial asset manager | Low risk, emphasis on reliable yield of a set minimum of income, mix of stocks and bonds |
| BTF, Bhutan | UNDP treasury department | Very low risk: US Dollar short term deposits and government bonds |
| FONANPE, Peru | Domestic asset manager | Same as government funds are invested |

- **Cost** -The asset manager is cost-effective relative to other asset managers with similar responsibilities.

*Experience and Reputation*

- **Experience** - Extensive in terms of years, foreign and local clients, and specific asset types which are relevant to the trustee's needs and objectives.
- **Reputation and Rating** - Based on reference checks, reputation is excellent; international rating is top (AAA or AA) and has high client retention rates.
- **Management and Staff** - Are competent, highly professional and compatible with foreign and local investors; generate significant business volume.
- **Social and Environmental Responsibility** - Asset Manager can offer options to adapt the portfolio to criteria the client may propose regarding issues of social and environmental responsibility.

*Safety and Stability*

- **Safety and Stability** - The asset manager maintains investment philosophy and portfolio which minimizes exposure to risk, as demonstrated by historical and current portfolio; has no history of legal difficulties, can ensure that assets are protected from being used in any way than that intended; is not affiliated with financially unsound institutions or politically vulnerable countries.
- **Liability** - The asset manager has a fiduciary responsibility and is held legally responsible for a "standard of care" which ensures that funds are not misused; and is not eligible for any indemnity from the Trustee (or at most, only indemnity for losses due to Trustee negligence).
- **Risk Management Systems** - The asset manager has capability and flexibility to invest in long-term assets, regularly employs mechanisms (e.g. automatic stops) for avoiding losses due to large movements in markets, capability and flexbility regarding use of hedging instruments, and capability and flexibility to diversify investments across countries and asset types.

When selecting from among several asset managers, care must be taken that relevant performance records are compared. For example, a ten year track record in bond management does not provide information about the manager's ability to manage stocks. Track records should be made available upon request. These are usually comparisons to either the performance of the entire market, for example all international stocks in a weighted index (e.g. Morgan Stanley International Capital Index) or relevant sectors of the market (e.g. only AAA rated bonds). Past performance, however, may be a guide but is no guarantee of future performance. Many asset management groups are wholly owned subsidiaries of major international banks. To check the financial soundness, credit ratings of the bank and parent institution should be easily obtainable from the asset manager. The history of the company can also be indicative. Has the group existed 5 or 50 years? In some countries, insurance on bank deposits may be obtained, sometimes automatically.

The use of a banking group with a regional and/or international exposure may also help attract large corporate donors who are active investors in the region of the project. Often a banking group which is well established in a developing country serves as the link between the corporation and the developing countries. Thus, a trust fund associated with such a bank may be able to solicit corporate donations. Furthermore, the bank may actively help the trust fund raise funds from corporate donors.

## Selection of Asset Management Services and Fee Structures

The selection of a trust fund asset manager does not fit neatly into the Bank's Guidelines for the selection and employment of consultants[3] However, many of the same principles and practices, appropriately adapted, should be applied. Selection should be based on competition among pre-qualified asset managers. The competing banks or firms should be provided the same information about the trust objectives and income needs, as well as the criteria serving as the basis for selection, and asked to prepare written proposals. Fees, which are discussed below, while a factor in selection, are not easily comparable, and therefore should not be included among the formal selection criteria. It may also be advisable to engage an independent financial expert to advise on the selection process as was done for the Uganda MBIFCT.

**Is there a correlation between location of the asset manager and performance in the different markets?** It depends on the basis of comparison. For general equities and fixed income securities, there is usually not a significant difference in capability in asset management between major international banks. Most international asset managers have offices and research bases in all major markets and regions. Furthermore, all investment companies buy research on markets and securities from locally based banks. For example, a Swiss bank may have a branch in New York which does some research on US stocks, but it will also buy research on US markets from American firms. Any US management firm will also buy research on US securities, even though it has its own capacities for in-house research. This is true for all major markets.

For some derivative products (e.g. options, mortgage guaranteed securities, futures, etc) which are only traded in the US markets, an American based firm may have an advantage due to familiarity with the product. However, these specialized products are not likely to be common features of conservative portfolios such as conservation trust funds.

In conclusion, the asset management needs of a conservative trust fund will most likely be met by any large international, top ranking banking group or investment firm, regardless of location and national origin.

### *Management Fees*

Although asset management fees are an important criterion in selecting an asset manager, they should not be an overriding concern. Quality of investment service and security of assets are the most important factors. Furthermore, in today's largely deregulated markets, most management services are competitively priced. It is also difficult to compare exact total costs of asset

**Uganda MBIFCT - Asset Manager Selection**

To assist the Ugandan trust design team in selecting an asset manager, the services of an independent financial adviser (an individual) were engaged. Terms of reference for the financial adviser specified the information the adviser was to obtain from each firm; this formed the basis for the criteria used to prequalify and select the asset manager.

The adviser first issued a general enquiry to 29 prequalified international banks/firms to which 12 responded to which 11 responded by submitting detailed proposals. The adviser evaluated the proposals, identified the 3 highest ranked banks/firm and ranked them in turn. A detailed report of his evaluation was provided to the Ugandan team.

Funded by a GEF Project Preparation Advance, the Ugandan team interviewed the top 3 ranked banks/firms with the financial adviser and established their own ranking.

***Results worth noting:***

- The Ugandan team's ranking of the firms was not identical to that of the financial adviser. This was nonetheless acceptable as all three firms were considered to be of high caliber with only minor differences. The financial adviser stressed the importance of a comfortable working relationship as a factor in the selection, with the interview process being a key factor in establishing this.
- Fee estimates were included in the information to be obtained by the financial adviser, but they were not a deciding factor in the selection. The selected firm's fees were the second lowest, rather than lowest in cost of the 3 candidates.
- The financial adviser was kept on retainer while the banks/firms were preparing their proposals which was useful to answer inquiries from the banks/firms. Keeping the adviser on retainer throughout the interview and selection process is highly advisable.

management due to the wide variety of fee structures offered. *Annex 4* provides the basis for establishing fees and various examples.

## Other Investment Issues

### *Investing in Emerging Markets and the Use of Mutual Funds*

**Should part of the funds be invested domestically or in the region of the Trust Fund?** As outlined above, diversification refers both to the type of security, the quality of the security, and the home market and currency of the security. Global diversification refers to the distribution of investment over a range of markets. "Emerging Markets" refers to the capital markets in developing countries. It is sometimes possible to invest in the markets of country or region served by the trust fund bringing an additional benefit to the country of the trust. A full discussion on the benefits of and issues concerning investing trust fund assets in local capital markets is beyond the scope of this paper. It must be noted that volatility tends to be high in these markets, and other risks do exist. However, a brief outline of the main benefits of investing a small portion of funds in emerging markets is warranted:

- Many regional emerging equity markets have been stellar performers and are expected to continue outperforming OECD equity markets

- "Emerging market funds" support and strengthen regional capital markets.

These markets require intensive specialized professional asset management skills which are very different than those required to manage the rest of the portfolio. Mutual funds may be a good option for those trust funds which desire investments in emerging markets. Mutual funds are pooled assets which are professionally managed for a fee. The advantage is professional management for a specific investment goal and economies of scale because the funds are pooled. Mutual funds usually follow a specific investment theme, invest in a specific industry or geographic region, or provide tax-break benefits. They can be ideal investment vehicles for small quantities of money. Furthermore, mutual funds reduce the risk of high volatility by widely diversifying the investments across a range of countries. A global emerging market fund offers perhaps the greatest advantage of growth and supports a wider range of capital markets. The asset manager should build the investment strategy, incorporating the percentage that will be managed in a mutual fund. For example, for a portfolio which may have 25% of its assets invested in global equities, the fund manager may decide to allocate 3% to an emerging market fund. The remaining 22% are invested in other markets accordingly. (See *Annex 4* for a listing of recent performance of mutual funds invested in regional emerging markets.)

The major disadvantage of mutual funds is the lack of personally tailored management. The funds are pooled, and client's individual needs are not taken into consideration. Therefore, it may not be appropriate for the entire portfolio, nor large portions of it, but is not a serious limitation for small percentages of the portfolio. The other disadvantage of mutual funds include the extra management fee, which can be up to 7% of the assets invested. Fees can be waved or greatly reduced if the mutual fund purchased is managed by the same company who is managing the trust fund portfolio. Therefore, it may become a criterion for asset management selection that the company offer competitive, top ranking mutual funds.

The second situation in which a trust fund may consider using mutual funds is if the trust fund is managed outside of the United States. A tax-exempt mutual fund may be used to invest in US stocks. Certain restrictions apply, but the options should be considered for those non-US based trust funds which desire a small portion of US equities.

### *What is socially and environmentally responsible investing?*

One of the most challenging tasks facing today's business leaders is the development of effective responses to our rapidly evolving social, economic, and geo-political surroundings. The modern business corporation is generally perceived to be legitimate because it appears to fulfill its implicit contract with the public: to produce the goods, services, utilities needed for the provisioning and prosperity of society. It is further validated by the products of those activities, including dividends and capital gains investors, employment, and development of new technology. But 'business as usual' can no longer be conceived in such clear cut terms, and many outputs of business activity (e.g. pollution, deforestation) can no longer be considered beneficial.

Socially and environmentally responsible investing recognizes that capital markets are not neutral and have a role to play in promoting sustainable development. All investors, including passive investors who hold pension plans or endowments are stockholders who can 'vote with their share' in at least three ways.

An estimated $650 million is not invested in the US following some range of social, environmental, and ethical criteria.[4] Pension funds, trade unions, educational and religious organizations have been among the first to demand that their social or environmental concerns be reflected in their investments.

The most common method of socially and environmentally responsible investing is to establish investment screens. Screens are a list of criteria, be it ethical, social, or environmental, through which all investments must pass before they are allowed to be purchased. This is known as a 'negative' method, because it results in investments not flowing to certain types of companies. Some of the most commonly employed negative screens work to exclude investments in the defense and tobacco industries.

The "positive" method focuses investments on companies which are found to be doing something beneficial for society or the environment. These funds might invest in industries which have better than average environmental track records or are improving equal opportunity employment practices.

The third route is active participation by shareholders to call upon companies to improve their social and/or environmental record. Although this method is slowly making an impact on companies, it is not a practical route for the trustees who will be unable to attend annual shareholders meetings which are mostly held in the US and Europe.

The use of social and/or environmental screens does not necessarily hurt the performance of the investments. On the basis of performance of a socially responsible investment index (Domini Social Index in the U.S.), there is no indication that broad social screening leads to under performance or has a great impact on the performance of a fund. However, it does appear that these types of funds can be slightly more volatile.

Conservation trust funds may consider the use of investment screens. There are numerous socially and environmentally responsible mutual funds which are traded on the US and UK stock market. However, it is unlikely that the investment screens employed by any of the mutual funds will match exactly the concerns of the conservation trust fund. The board of directors can devise an approach and work with the asset manager to implement it. It is recommended that trust funds wait until the mid-term review to consider employing investment screens. Devising the right screens is a laborious project, and should not distract from the main concerns of the board of directors in the first few years.

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[1] "Quality" assets are defined as securities of companies listed on major stock exchanges and highly rated bonds.

[2] For example, the Standar and Poors 500 or Wilshire 5000 indices for international and emerging markets, US international bond funds, published "track records" of major fund managers.

[3] Guidelines: Use of Consultants by World Bank Borrowers and by the World Bank as Executing Agency (Washington, D.C., World Bank, August 1981)

[4] Tennant, T., Campanale, M., "A Long-Term Investment", Environmental Strategy Europe, 1991

# 8. The World Bank's Role in GEF Trust Fund Design and Supervision

This chapter sets out the role of the Bank throughout the life of the GEF project and beyond and provides guidance on the composition of the task team needed to design a trust fund.

### Summary of Main Points

Functions of the Bank will include:

- reviewing the alternatives to and the prerequisites for a trust fund and making the case for a trust fund should the conclusion be that this is the most appropriate mechanism;
- assembling a task team of specialized expertise covering the special biodiversity, legal and financial aspects of trust fund design;
- assisting the client government and/or local trust fund design committee in the design of the trust fund, including identification of the activities which would be financed from the trust fund;
- reviewing and commenting on acceptability of key legal instruments and design features (trust deed, by-laws, investment strategy, asset manager selection process, procedures for procuring goods and services using trust income)
- supervising implementation of the project to which the trust fund is attached;
- ensuring that the goals of the GEF are met in the long run (i.e. beyond the "project life").

The first responsibility of the task manager is to review the alternatives set out in Section 2.3 of this paper to determine whether a trust fund is the most appropriate means of meeting the conservation challenge in the country. The case for a trust fund should be put forward in the initial GEF-PID (IEPS). Once this has been reviewed and the decision to proceed taken, the prerequisites for a trust fund outlined in Chapter 2, page 15, should be fully discussed with the client government and the composition of a local trust design committee sketched out.

For the design and structuring of a trust fund, the task manager should be supported by a team including biodiversity specialists, a financial analyst who inter alia, will project income needs to aid in determining the size of the trust fund and minimum acceptable return, legal counsel on domestic and off-shore legal issues (most often in addition to the country lawyer), and possibly financial expertise to aid the client with selection of an asset manager (in some cases, this expertise can also provide the needed financial analysis). Funding required above and beyond the task manager's administrative budget for the project can be sought from Consultant Trust Funds or the GEF project preparation facility, the PPA (the latter in particular for experts who should be engaged and report to the government or trust design committee such as legal counsel or a financial expert).

The key trust fund design issues which should be satisfactorily resolved for the Bank: taxation (Chapter 5, *Taxation*, page 36), attachment (*Risk of Attachment*, page 37), security of the assets (*Security of Assets*, page 38) and elements which ensure that the trust objectives will be met (*Ensuring Trust Objectives Will Be Met*, page 39). Input from competent and experienced legal counsel early in the preparation stage is critical.

The trust funds established with GEF support will, in almost all cases, continue operations after the life of the "project" which normally designs and vests the trust fund. The "project life" is an arbitrary period of sufficient length that it allows the Bank and donors to determine whether the trust is operating as designed and use of funds is consistent with the donors' requirements. In addition to standard supervision, a mid-term or other period review should be a standard feature of trust fund design. Even after the "project life", there should be provision for periodic consultation with the main parties concerned (government, trustee(s), board of directors).

**Box 8.1 Examples of the Role of the GEF-World Bank in Designing and Supervising Trust Funds**

**Examples from Uganda and Bhutan**

**Uganda: MBIFCT**

The World Bank task manager was instrumental in encouraging a very broad representation of Ugandan interests in the design of the trust fund. The World Bank will approve the board's initial membership and oversee the procedures set out in the Trust Deed and By-Laws for replacing board members. The Trust Deed and By-Laws can not be modified without the World Bank's consent during the first five years. The World Bank also prefers if the Trust Manual is not modified without their approval. The World Bank, as Trustee of the GET, has declined to be represented on the Trust Management Board but may participate as an observer.

**Bhutan Trust Fund: BTF**

To ensure that the funds are used for purposes consistent with GEF, that BTF has adequate guidance over the long term and that resources are adequately managed, the World Bank had reviewed the Memorandum of Understanding which provides for a management board to oversee BTF activities, the organization and management of the trust's governing body, and the financial management arrangement with UNDP. The World Bank also reviewed the proposed program of activities to be implemented over the first five-year period. GEF is represented by UNDP on the Board of Trustees. The supervising task team has been instrumental in advancing the establishment of the administrative framework for BTF management and ensuring that systems for accounting, disbursement and reporting on asset management are instituted. A decision to extend supervision beyond the 5-year project life could be taken if progress in achieving objectives is slower than anticipated. Even after the project life, the Bank could request the return of the GEF contribution if trust objectives are not being met.

# 9. GEF Umbrella Fund (GUF)

This chapter introduces the concept of a single umbrella trust fund, either created under under the GEF-World Bank or as a separate entity.

## Summary of Main Points

- A "GEF Umbrella Fund" (GUF) could be created to house new conservation trust funds.
- Each trust fund could benefit from tax exemption, freedom from attachment and security of assets. Advantageous asset management arrangements would also be possible.
- There are a number of legal, resource and practical considerations which need to be considered before deciding to proceed with an umbrella fund.

## Key questions addressed by this chapter:

- What is a "GEF Umbrella Fund"?
- What would be the major advantages of such a fund?
- What considerations remain to be examined before deciding to proceed with a GUF?

## The GEF Umbrella Fund (GUF)

An "umbrella fund" could be used to house individual conservation trust funds which are supported by GEF financing. Options might include establishing the umbrella fund either as a separate trust fund under the auspices of the Bank or GEF, or as a separate legal entity. Each individual trust fund could be a restricted sub-account with its own purpose, beneficiary(ies) and local governing body — operating at the local level as a separate and independent trust.

## Advantages and Considerations

The GUF trust funds would benefit from the Bank's tax exempt status, and would not be vulnerable to attachment. The assets could be securely invested with top quality professional asset managers (in-house or from the private sector). The funds could be revocable to GEF, and therefore concerns of frustrating the individual trust fund objectives could be minimized. Because several important design issues could be resolved expeditiously, the time and resources required to set up a multitude of customized trusts would be greatly reduced. Furthermore, GEF funds might be used more effectively to leverage other financing: donors might find such an arrangement more reassuring owing to reduced risk and systematized financial reporting and auditing.

In addition:

- Control systems could be somewhat standardized, and centrally evaluated.
- Commingling would allow for:
  - creation of smaller funds (under US$ 4-5 million) initially.
  - economies of scale and lower transactions costs, and a likelihood of better returns with lower volatility;
  - greater possibilities to invest in emerging markets and socially responsible funds;
  - eased communications between the board of directors and asset manager.
- Disbursement would be easier to monitor.

### *Important Considerations*

- The establishment and operation of a separate entity to run GUF may require significant resources. However, in the long run, there may be major resource savings when compared to establishing many individual trust funds.
- The legal implications would need to be fully explored, particularly as these relate to goals and structure of the Global Environment Facility.
- Some countries may perceive a loss of ownership as well as "loss of control" over their trust fund if it is housed under a central umbrella, possibly centrally invested and revocable to the GEF.
- There might be some loss of capacity building in financial management if the GUF has the major role in asset management decisions. This might be lessened by ensuring the integration of client country experts into the GUF or structuring the GUF around a family of specialized funds, similar to mutual funds, in which trust managers could place and then move trust fund assets.

The potential benefits of a GUF warrant further examination. Many of the difficult issues (tax liability, attachment) and time intensive design factors (customized trusts, selection of asset manager) which now absorb resources and lengthen considerably the time required to establish a trust might find a simpler, more expedient resolution. However, the "costs" of establishing and operating a GUF must be examined and careful thought needs to be given to designing a GUF which could maintain many of the secondary benefits of trust funds which accrue to client governments.

# Profiles of GEF-Supported Trust Funds

## Slovak Republic Biodiversity Protection Project
## Poland Forest Biodiversity
## Ukraine Trans-Carpathian Mountains Biodiversity Protection Project

### Foundation for Eastern Carpathian Biodiversity Conservation

*Objective of the Foundation:*

The Foundation will be established to fund joint transborder ecosystem management and protection activities and the establishment of research and monitoring capabilities within the participant countries.

*Size of Fund:*

| | |
|---|---|
| Initial Size: | US$ 600,000 |
| Growth Objective: | not specified |

*Role of GEF:*

The GEF will provide one of two initial contributions of US$ 300,000 each to vest the fund.

*Other Donors:*

The MacArthur Foundation financed assistance from WWF to design the Trust Fund and provided the second of the initial contributions.

*Status of Trust Fund:*

A framework agreement to establish the Foundation was signed September 16, 1993 by the three Governments, the MacArthur Foundation and WWF. The Deed and By-Laws have been agreed by the five parties and registration is anticipated for May 1994.

*Special Design Features:*

No part of the Foundations's initial capital may be withdrawn to fund activities, and a maximum of fifteen percent of income can be used to cover administrative costs. The foundation will be established in Switzerland as a charitable organization and must have a Swiss citizen on its board of directors. The board of directors will comprise 14 other members: four appointed from each country, one from WWF, and one from the MacArthur Foundation. Decisions will require affirmative votes from 9 of the government appointed members and one of the NGO members. Day-to-day activities will be conducted by an executive committee which is a balanced subset of the board.

## Uganda: Conservation of the Bwindi Impenetrable National Park and the Mgahinga Gorilla National Parks

## Mgahinga and Bwindi Impenetrable Forest Conservation Trust (MBIFCT)

### *Objective of the Trust:*

The trust beneficiaries are two forests in Uganda which are among the most biologically diverse forests in East Africa. The main objective is to provide reliable, long-term financing for incremental support for park management and research and to help local community groups develop economic activities which will provide alternative means of meeting needs which were traditionally met by harvesting forest resources.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size | US$ 4 million |
| Growth Objective: | not specified |

### *Role of GEF:*

The GEF financed through a preparation advance of about US$ 165,000 community consultation and technical assistance to design the fund and provides the initial funding of US$ 4 million.

### *Status of Trust Fund:*

The Trust Fund was established on February 22, 1994.

### *Special Design Features:*

MBIFCT will be established as an independent body under Ugandan law. The assets will be managed by an offshore professional asset manager . The governance has been carefully arranged so that the interests of the local communities are addressed. A Trust Management Board (TMB), consisting of representatives from the National Parks, the Forest Department, national and international NGOs, a research institute, the private sector, and residents of the three affected districts, will serve as Trustees of the funds. A local steering committee will serve as the main liaison between the TMB and the communities. A trust administration unit and technical advisory committee (including ecological/environmental sociologist, economic expertise) will be established.

## Bolivian Biodiversity Conservation Project
## Cuenta Fiduciaria para el Sistema Nacional de Areas Protegidas (CF/SNAP)

### *Objective of the Trust:*

The trust fund will finance the recurrent costs of the management and operations of the priority protected areas belonging to the National System of Protected Areas (SNAP), the central support programs of the SNAP and the National and Regional Directorates of Protected Areas.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | US$ 1 million |
| Growth Objective: | US$ 35 million by end-1997 |

### *Role of GEF:*

A GEF project preparation advance of US$ 40,000 was granted to finance legal counsel to identify an appropriate legal structure for the fund to achieve its objectives and with regard to potential tax and attachment issues.

### *Status of Trust Fund:*

The fund was created June 17, 1993 and received an initial contribution of US$ 1 million from the Swiss Development Cooperation.

### *Special Design Features:*

The fund is part of the structure of the Fondo Nacional para el Medio Ambiente (FONAMA), the Government environmental umbrella fund. Morgan Guaranty Trust Company is Co-Trustee and asset manager. The fund is governed by an administrative council established under the by-laws of FONAMA.

### *Objective of the Trust:*

The proposed trust/sinking fund would support recurrent costs of long-term activities designed or identified during the initial phase of the Brazil Biodiversity Project to produce long-term gains in biodiversity conservation through public and private sector partnerships.

## Brazil Biodiversity Project

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | US$ 20 million |
| Growth Objective: | To be determined |

### *Role of GEF:*

The GEF supported project will finance the design of the sinking fund and contribute US$ 20 million. The project will also finance efforts to seek additional contributions to the fund.

### *Status of Trust Fund:*

Establishment expected in mid-1995.

### *Special Design Features:*

The trust will be organized as a sinking fund with a life of 20 years to be managed by a Foundation assisted by an Executive Secretary, the asset manager, and an administrative agent and technical committees.. It is expected that the principal of the fund will be held offshore and invested by a professional asset manager, with oversight by a board of experienced financial experts. A portion of the income and principal of the fund would be used each year to support projects approved by the Foundation's Board of Governers.

## Bhutan Trust Fund for Environmental Conservation (BTF)

### *Objectives of the Trust:*

The main objective is to assist the Royal Government of Bhutan (RGOB) in conserving its forests and preserving their rich biological diversity. The income generated during the first five years will fund the establishment and management of a national system of protected areas and the development of institutional capacity and human resources to manage the system.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial size: | US$ 9.5 Million |
| Growth Objective: | US$ 20 Million |

### *Donors:*

| | |
|---|---|
| GEF | 7,000,000 |
| WWF-US | 1,000,000 |
| Norway | 586,725 |
| Netherlands | 948,163 |

### *Role of GEF:*

The GEF contributed US$ 7 million to vest the fund. An additional US$ 3 million would be added when actions are met relating to reform of key institutions and the protected area system.

### *Special Design Features:*

The trust was established under the auspices of UNDP which ensures a tax-free status. The funds are invested by UNDP's Treasury Section. WWF-US and UNDP both sit on the Board of Directors with three representatives of the RGOB. Decisions will be adopted by a four-fifths majority of full membership The World Bank will formally supervise the fund for the first five years of its operation or until the second tranche is released, whichever comes later.

### *Status of Trust Fund:*

The fund was established March 6, 1991.

## Seychelles Biodiversity Conservation and Marine Pollution Abatement Project
## Seychelles Island Foundation

### *Objective of the Foundation:*

The Foundation manages two World Heritage Sites: Aldabra, the world's largest coral atoll and the Vallee de Mai National Park.

### *Size of Trust Fund:*

Initial Size: Undetermined (assets were transferred from the Royal Society when the SIF was created to replace it)

### *Role of GEF:*

Through the GEF project, SIF management and scientific capabilities will be significantly strengthened.

### *Status of Trust Fund:*

In 1979 SIF was established as a public charitable trust under the laws of the Republic of Seychelles.

### *Special Design Features:*

The President of the Republic is the Patron of the SIF. The Foundation enjoys a tax exempt status.The Board of Trustees has 14 members who serve for no more than three years and are both local and international. Not less than three represent the interests of the Seychelles's government and not less than five represent organizations concerned with conservation. Currently the Board of Trustees is comprised of half locally based professionals, representing community development, tourism, Ministry of the Environment and of Education, a local NGO and UNESCO. The overseas member represent large conservation agencies and NGOs such as IUCN, Society for Nature Conservation, ORSTOM, the Smithsonian, as well as individuals serving in their own capacity.

The Foundation is currently operating as a revolving fund, based on annual receipts from the Vallee de Mai National Park.

## Congo Wildlands Protection Project

### *Objective of the Trust Fund:*

The Trust Fund would support a portion of the recurrent costs of the protected areas whose improvements will be financed by the GEF supported project.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | To be determined |
| Growth Objective: | To be determined |

### *Role of GEF:*

The GEF will provide US$ 300,000 under the Wildlands Protection Project to design, establish, and promote the trust fund.

### *Status of Trust Fund:*

It is expected that the trust fund will be established by year three of the GEF project, i.e. sometime in 1996.

## Lao PDR Wildlife and Protected Areas Conservation Project

### *Objective of the Trust:*

Long-term financing of recurrent costs for operating and managing the Lao PDR protected areas system and other conservation activities.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | To be determined |
| Growth objective: | To be determined |

### *Role of GEF:*

The Wildlife and Protected Areas Conservation Project provides for six months of expertise for the design of the administrative, legal and financial aspects of a conservation trust fund, as well as its establishment.

### *Status of Trust Fund:*

It is expected that the Trust Fund will be established two to three years after the start of the project.

## Ukraine Danube Delta Biodiversity Project

### *Objective of Trust:*

The Trust Fund would fund the recurrent costs of the expanded protected areas in and around the Ukraine portion of the Danbue Delta.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | To be determined |
| Growth Objective: | To be determined |

### *Role of GEF:*

The GEF Danube Delta Biodiversity Project provides US$ 12,200 for technical expertise to design the legal, administration and financial constructs of the trust.

### *Status of Trust Fund:*

The trust fund will be prepared in year 3 of the project. At that time a realistic estimate of annual recurrent costs will be possible from which the size of the trust fund can be defined.

## Peru Trust Fund for Conservation Units
## Fondo Nacional para les Areas Protegidas por el Estado (FONANPE)

### *Objective of Trust:*

The goal is to provide sustained and predictable funding for Peru's key protected areas to ensure survival of a representative, viable sample of Peru's biodiversity. The income generated would finance park management, and upgrade the training and development of management plans.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | US$ 4 million |
| Growth Objective: | US$ 20 million after five years |

### *Donors:*

| | |
|---|---|
| GTZ: | US$ 1.5 million (outside of trust) |

### *Role of GEF in Trust Fund:*

The GEF will vest the fund with a $4 million contribution with the expectation of additional donor funds being made available after a three-year "proving" period. The GEF also made available preparatory funds of about US$ 19,000 for legal counsel on trust design.

### *Status of Trust Fund:*

The Decree Law creating FONANPE and PROFONANPE was issued December 29, 1992 and the Supreme Decree setting out the regulations governing them on July 16, 1993.

### *Special Design Features:*

FONANPE was created as an intangible trust fund. PROFONANPE is a not-for-profit entity under private law which administers FONANPE. The latter is governed by a management board consisting of: three representatives from the government, two from Peruvian NGOs and one from an international NGO. The board is advised by an independent technical committee of scientists and natural resource professionals. The funded protected areas will have their own advisory board, composed of local NGOs, local government officials, and indigenous groups where appropriate. The funded protected areas will have their own advisory boards, composed of local NGOs, local government officials and indigenous groups.

Funding from GTZ is being used to finance conservation activities and operating expenses of FONANPE/ PROFONANPE for the first two years, until the trust fund is vested and has built up some income.

## Belarus Biodiversity Protection Project
## Belovezhskaya Primeval Forest Foundation

### *Objective of Trust:*

The objective of the trust fund would be to sustain the biodiversity protection program for the Belovezhskaya primeval forest.

### *Size of Trust Fund:*

| | |
|---|---|
| Initial Size: | To be determined |
| Growth Objective: | To be determined |

### *Role of GEF in Trust Fund:*

US$15,000 in included in the Belarus Biodiversity Protection Project to develop the legal and financial frameworks as well as operating procedures for the trust.

### *Status of Trust Fund:*

Design work will begin in 1994.

# Profiles of Other Biodiversity Conservation Funds Structured as Trusts or Foundations

## Belize
## Protected Areas Conservation Trust (PACT)

### *Objective:*

The fund will support and help coordinate the nationwide effort to establish, operate, maintain, and enhance protected areas, and other natural and cultural protected resources for the propose of conservation and maintenance of biodiversity.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $ 2 million per year |
| Growth Objective: | To be determined |

### *Role of International NGO:*

An international NGO representative will be on the Board of Directors, Advisory Council, and Honorary Board.

### *Status of Fund:*

Recent change in the government has slowed down progress in developing the fund.

### *Special Design Features:*

Funding for this revolving fund will come from a $20 per person fee collected from foreign tourists. In addition, it is expected that 20% of all site entry fees, recreation related licenses and permit fees as well as concession fees to be collected at individual protected areas will be put in the fund.
Funds can be invested in the short term, but it is expected that 95% of the funds raised in a given year will be spent in the following year.

The Board of Directors will consist of nine members: one from a conservation NGO, one from a rural development organization, one from village councils, three government representatives, and one member at large elected by the other members of the board. PACT's Financial Secretary and Executive Director will be non-voting members of the board. A majority vote is necessary for decision making. An "Honorary Board" of three to five persons will help enhance and portray the role of PACT; members may include public figures and representatives of prominent international NGOs. An Advisory Council, consisting of 11 representatives of relevant public sectors, NGOs and one at large member will prepare a five year National Strategic Plan to outline policies and direction for PACT.

## Colombia
## Ecofondo

### *Objective of Trust Fund:*

To strengthen the capacity of NGOS to implement projects and promote co-management of the protection of Colombia's natural resources at a regional level between government agencies and NGOs.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $ 6 million |
| Growth Objective: | To be determined |

### *Role of NGOs:*

NGOs were instrumental in creating the fund and will have majority membership in the Board of Directors.

### *Status of Trust Fund:*

The statutes of Ecofondo were approved in a constitutional assembly on February 6, 1993.

### *Special Design Features:*

The fund is structured as a private, non-profit corporation and is intended to operate as an endowed fund. The initial contribution to the fund was received through the Enterprise for the Americas Initiative.

The governing structure will include a General Assembly of 300 representatives of NGOs and State agencies. The General Assembly will elect Board members, define statutes and approve the budget. The Board of Directors will have seven members, five from the NGO community and two permanent representatives from Government, and will set policies and guidelines and establish the basic framework of the operations. The governance structure also includes technical committees, up to 12 regional advisory boards and an office of the Executive Director to manage fund logistics.

## Guatemala
## Fideicomiso para la Conservacion en Guatemala (FCG)

### *Objective of the Fund:*

To support conservation activities, strengthen both governmental and non-governmental organizations and promote sharing of responsibilities between those two groups.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | US$ 1 Million |
| Growth Objective: | US$ 10 Million |

### *Donors:*

US Commercial Bank, Whitley Foundation (UK), WWF

### *Role of International NGO:*

WWF was instrumental in creating the trust and vesting it.

### *Status of Trust Fund:*

The trust was created in April 1991 by three Guatemalan NGOs, WWF and the Banco del Quetzal. The first review of projects to determine eligibility for financing tool place in June 1993.

### *Special Design Features:*

80% of annual income will finance conservation projects with the remaining 20% reinvested.

The FCG is governed by a five-member Administrative Committee comprised of four voting members (3 local NGOs and WWF) and a non-voting member from the National Parks Commission. The Committee can be expanded to nine voting members, including public and private sector representatives.

# Honduras
# Fundacion VIDA

### *Objective of the Foundation:*

To promote and contribute to the conservation of Honduras' biological and cultural heritage by securing financial and technical resources to channel to organizations implementing programs of conservation, education and sustainable development.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | About $4.5 million |
| Growth Objective: | To be determined |

### *Donors:*

Government of Honduras, USAID, UNDP, National sources

### *Role of NGOs:*

Funds are given to locally based projects developed by Honduran NGOs and which respond to the following priorities: (1) conservation of ecosystems and protection of biological diversity; (2) environmental and ethno-cultural education; (3) conservation and sustainable management of watersheds; and (4) pollution control.

### *Status of the Foundation:*

The foundation was granted legal status on April 2, 1992 by Presidential Resolution.

### *Special Design Features:*

Fundacion VIDA finances the implementation of environmental projects through other organizations.
The highest level governing body is a General Assembly which is made up of dues-paying associates acting either in their individual capacities or as representatives of institutions. The General Assembly elects the Board of Directors which is composed of prominent individuals and institutions from different parts of the country who are working in the environmental field. The Board of Directors then select an Executive Director who hires a technical and financial administrative team.

# Jamaica
# Environmental Foundation of Jamaica (EJF)

## *Objectives:*

The goal of the foundation is to fund projects in the areas of restoration, protection or sustainable use of marine environment, animal and plant species, parks and reserves; development and implementation of sound systems of natural resource management and conservation programs; development of training programs to strengthen conservation institutions, generate knowledge and increase public understanding and commitment to conservation; and support agriculture related activities and farming approaches to benefit the environment.

## *Size of Fund:*

| | |
|---|---|
| Initial Size: | About $ 2 million |
| Growth Objective: | $ 21.5 million over 10 years |

## *Role of NGOs:*

Two Jamaican NGOs, the Jamaica Conservation and Development Trust and the National Environmental Society Trust, were involved in developing the framework agreement for the fund.

## *Status:*

The fund was established in December 1991 as the result of a bilateral debt reduction agreement. The first project grants were made in August 1993.

## *Special Design Features:*

The EJF is a limited liability company with membership open to NGOs with interest in the environment and child welfare. Funding is by interest payments from renegotiated debt under the Enterprise for the Americas Initiative. It is expected that the fund will operate as an endowment.

The EJF is governed by a Board of Directors.

All funds are held in Jamaican Government securities. A professional investment portfolio manager will eventually be hired to manage the assets.

# Jamaica
# National Park Trust Fund

### *Objective of the Trust:*

To support the operations of the national park system.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $ 447,956 |
| Growth Objective: | To be determined |

### *Donors:*

USAID, Conservation Trust of Puerto Rico, The Nature Conservancy, Jamaican Commercial Bank

### *Role of International NGOs:*

The Nature Conservancy is one of the original contributors to the trust fund.

### *Status of the Trust:*

The trust was legally established in January 1991.

### *Special Design Features:*

The JNPT is the vehicle for all eligible funds to the park system, whether public or private.

The trust is governed by a Board of seven persons, including three from the Jamaica Conservation Development Trust which administers the JNPT. The four other members are appointed by the Natural Resources Conservation Authority of the Government of Jamaica and include private sector and university representatives.

A professional portfolio manager has been contracted to manage the Fund's investments.

## Philippines
## Foundation for the Philippine Environment, Inc.

### *Objective of the Foundation:*

The Foundation will support the sustained management of natural resources and the preservation of biodiversity in the Philippines. To meet this objective, the Foundation will provide technical, managerial and financial support to NGOs, people's organizations, communities and other environmental protection, sustainable development, and conservation groups. In particular, the Foundation will support Philippine NGOs who lack resources of sustainable funding and technical assistance. The Foundation will also support eco-tourism efforts.

### *Size of the Fund:*

| | |
|---|---|
| Initial Size: | US$ 9.2 Million (Peso equivalent of US$ 9 Million from a debt-for-nature swap funded by USAID and US$ 200,000 from a debt-for-nature swap donated by the Bank of Tokyo. |
| Growth Objective: | To be determined |

### *Role of International NGO:*

WWF executed the debt-for-nature swap which generated the initial US$ 9 million contribution. WWF is also a member of the Board of Directors.

### *Status:*

The Foundation was incorporated in 1992.

### *Special Design Features:*

This is a non-stock, non-profit corporation under the laws of the Philippines. Not more than 20% of the assets can be used for administrative purposes. The assets are invested in Philippine government securities earning market rate of interest. The Foundation is governed by a Board of Directors who represents a broad spectrum of development NGOs, environmental NGOs, business groups, governmental representatives, and WWF. There are Regional Committees based in major provincial centers. These committees will establish regional guidelines for priorities for foundation funding. The committees will develop monitoring and evaluation capabilities and review grant proposals.

## Dominican Republic
## Fondo Integrado Pro Naturaleza (Pronatura)

### *Objective:*

PRONATURA serves as a liaison among national organizations from the public and private sector that are committed to the conservation of natural resources, preservation of biodiversity and environmental protection by providing technical and financial assistance as well as facilitating information exchange.

### *Size of Fund:*

Initial Size: NA As of May 1994, PRONATURA had disbursed $5.8 million.
Growth Objective: NA

### *Donors:*

Puerto Rico Conservation Trust, MacArthur Foundation, The Nature Conservancy/U.S. Agency for International Development (Parks in Peril), UNDP/GEF Small Grants Programme.

### *Role of NGOs:*

The seven-member Board of Directors is elected from representatives of NGOs.

### *Status of the Fund:*

PRONATURA was established on January 30, 1990 and began disbursing in 1991.

### *Special Design Features:*

PRONATURA currently operates as a sinking fund. Donations are converted to national currency at the official exchange rate as they are received and immediately deposited in separate accounts for each project.

PRONATURA 's governance structure includes a General Assembly, formed by its governmental and nongovernmental organization founding members. The General Assembly meets annually to elect the Board of Directors

# Indonesia
# Indonesian Biodiversity Foundation (IBF)

### *Objective:*

IBF has four stated goals: (1) to strive for conservation of natural resources, (2) to promote the emergence of policies, programs and efforts for the conservation, utilization, management, study and maintenance of biological resources and their diversity, (3) to initiate and promote regional, national and international cooperation among NGOs, scientific, research and educational institutions; the business community; and government agencies and (4) to foster and improve the capabilities of society and its institutions to play an active role in efforts for the conservation and utilization of biodiversity in a fair, equitable and sustainable manner.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $20 million |
| Growth Objective: | To be determined |

### *Donors:*

USAID, Japan, Biodiversity Support Program

### *Role of NGOs:*

Seven members of the 23 member Board of Trustees represent NGOs

### *Status of Fund:*

The Foundation was legally registered on 28 February 1994. The endowment fund is expected to be transferred by USAID to IBF on an installment basis between the end of 1994 and early 1996.

### *Special Design Features:*

Although no current statutory definition exists in Indonesian law for a foundation, foundations have a long history in the country and are able to enter into contracts and civil actions.

## Mexico
## Fondo Mexicano Para la Conservacion de la Naturaleza

### *Objective:*

The main objective is to support and strengthen the capacity of Mexican NGOs through mid- and long-term financing of their biodiversity conservation activities and in the search for alternatives for sustainable use of natural resources.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $ 30 million |
| Growth Objective: | $ 100 million over five years |

### *Donors:*

USAID, Government of Mexico

### *Role of NGOs:*

NGO led activities will be financed from income earned on the fund's assets.

### *Status of Fund:*

The Fund has been established and in 1994, was vested by the Government with $ 10 million.

### *Special Design Features:*

The Fund has been established as a non-profit NGO operating as an endowment.

The Board of Directors is composed of representatives fro scientific institutions, conservation, development, grassroots organizations, the private sector and the government. Four technical committees (evaluation, planning, administration and international), comprised of international and national conservation experts, advise the Board.

## Panama
## Fundacion Natura

### *Objectives:*

The fund's goals are to invest in the protection of natural resources and biodiversity in Panama, to initiative development of sustainable use systems and to contribute to the strengthening of NGOs.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | $ 25 million |
| Growth Objective: | To be determined |

### *Donors:*

Government of Panama, USAID, The Nature Conservancy

### *Role of NGOs:*

NGOs are represented on the seven-person Board of Directors. Small technical assistance grants will also be made to NGOs to strengthen their capacity.

### *Status of Fund:*

The Foundation has been created. In anticipation of activation of the fund, small grants have been made to local NGOs to help train staff. Small-scale conservation activities were also funded with additional USAID financing.

### *Special Design Features:*

The Foundation is a private, nonprofit association.

## Papua New Guinea
## National Conservation Trust Fund for Papua New Guinea

### *Objective:*

The fund will protect the environment and conserve biodiversity for the collective benefit of the people of PNG and their resources.

### *Size of Fund:*

| | |
|---|---|
| Initial Size: | The goal is 20 million Kina (equivalent to $ 22 million) |
| Growth Objective: | To be determined |

### *Role of NGOs:*

NGOs are likely to be members of the Board of Directors.

### *Donors:*

Funds will be sought from the Government of Papua New Guinea, GEF and bilateral donors

### *Status of Fund:*

The legal structure is under consideration.

# Sri Lanka
# Wildlife Trust of Sri Lanka

## *Objectives:*

The fund's objectives are to conserve and enhance environmental and economic values of Sri Lanka's natural heritage, to enhance wildlife and environmental education activities, to support elephant conservation, to support programs that compensate damage caused to human life, crops and property by elephants, to develop and sustain environmental tourism policies and programs, and to improve wildlife and protected area laws and regulations.

## *Size of Fund:*

| | |
|---|---|
| Initial Size: | $500,000 |
| Growth Objective: | NA |

## *Donors:*

USAID

## *Status of Fund:*

The Wildlife Trust of Sri Lanka was established in 1991 according to existing regulations governing charitable trusts in Sri Lanka.

## *Special Design Features:*

The Trust has a Chairman and a Board of Trustees with eight members, of which three are from the private sector.

The Trust also maintains profit-making tourism infrastructure in the Rendenigala/Rantambe Sanctuary. The 1993 work plan called for fund-raising efforts through sales of souvenirs and from a membership drive.

Endowment funds are invested in established commercial banks.

## TABLE 3: PORTFOLIO DISTRIBUTION BY FOCAL AREA

### Number of Projects

| | FY92 | | FY93 | | FY94 | | FY95 | | FY96 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | No. of Proj. | % of Total | No. of Proj. | % of Total | No. of Proj. | % of Total | No. of Proj. | % of Total | No. of Proj. | % of Total |
| Climate Change | 1 | 20.0 | 2 | 22.2 | 6 | 35.3 | 5 | 38.5 | 2 | 13.3 |
| Biodiversity | 3 | 60.0 | 6 | 66.7 | 9 | 52.9 | 5 | 38.5 | 6 | 40.0 |
| International Waters | 1 | 20.0 | 1 | 11.1 | 2 | 11.8 | 2 | 15.4 | 1 | 6.7 |
| Ozone Depleting Substances | - | - | - | - | - | - | 1 | 7.6 | 5 | 33.3 |
| Multiple | - | - | - | - | - | - | - | - | 1 | 6.7 |
| Total | 5 | 100.0 | 9 | 100.0 | 17 | 100.0 | 13 | 100.0 | 15 | 100.0 |

### Commitment Value (US$M)

| | FY92 | | FY93 | | FY94 | | FY93 | | FY96 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Value | % of Total | Value | % of Total | Value | % of Total | Value | % of Total | Value | % of Total |
| Climate Change | 3.3 | 4.5 | 35.5 | 50.8 | 59.1 | 52.0 | 42.5 | 42.7 | 10.1 | 8.0 |
| Biodiversity | 39.5 | 54.3 | 29.6 | 42.4 | 54.9 | 24.4 | 37.9 | 38.0 | 73.3 | 58.1 |
| International Waters | 30.0 | 41.2 | 4.8 | 6.8 | 23.8 | 20.8 | 17.0 | 17.0 | 2.7 | 2.2 |
| Ozone Depleting Substances | - | - | - | - | - | 2.8 | 2.3 | 2.3 | 35.7 | 28.3 |
| Multiple | - | - | - | - | - | - | - | - | 4.3 | 3.4 |
| Total | 72.8 | 100.0 | 69.9 | 100.0 | 137.8 | 100.0 | 99.7 | 100.0 | 126.1 | 100.0 |

# References for Additional Material

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## Reference for Endowments:

USAID, "Guidelines: Endowments from Appropriated Funds" (Draft version), February 17, 1994

## Reference for Disbursement Issues:

"Tackling Procurement and Disbursement Issues in Bank Financed Projects with Community Participation, World Bank, April 14, 1994

# Asset Management Strategies and Management Fees

This annex has 2 sections. The first looks at some of the possible asset management strategies for investment accounts. It offers as examples a few alternatives among the wide variety of options. The information presented is purely informative and not intended for the task team to use in advising the domestic trust design team or trust officials. It may be useful to engage professional financial counsel to assist the trust in the development of its investment strategy and interpretation of recommendations or options put forward by the asse manager.

The second section of this annex presents some "typical" fee structures for asset management.

### *Portfolio Construction*

The construction of a portfolio should always serve the investment goals and risk tolerance of the client. Once an asset manager has been selected (see selection criteria, Section 7.4 of Chapter 7), he or she will prepare a detailed investment strategy based on discussions with the client. The following issues must be clarified at that point:

- What are the main investment objectives: growth in market value, preservation of capital, income generation, or a blend?
- What is the time horizon for the investment account?
- What is the risk tolerance?
- What are the income needs? How often will income be transferred? (e.g. annually, bi-annually, quarterly)
- What will be the base currency? (e.g. US dollars, UK pounds, Swiss francs)
- Will the investments include stocks, bonds, or both?
- Will the investments be diversified outside of the base currency?

Strategies should be adaptable. As the client's needs change over time, so must the investment strategy. Chapter 7 discusses examples of changing risk and income strategies.

*Asset Mix.* In general, there are four broad categories of "asset mixes" for investment accounts. The first contains only bonds and bank deposits and is considered the most conservative and risk adverse. The second is a blend of stocks and bonds, but with usually less than 30% stocks. The third is a "balanced" account and is roughly evenly split between stocks and bonds. The last category is a stock account with close to 100% stocks. The blends and objectives are generalized below:

- **Bond Portfolio:** The primary objective is preservation of capital. A secure level of current income can be generated:

| | |
|---|---|
| 80-100% | Bonds |
| 0-20% | Bank Deposits |

- **Conservative Mixed Portfolio:** The primary objective is safety of principle and limited portfolio volatility with a high and secure level of current income.

| | |
|---|---|
| 60-80% | Bonds |
| 10-30% | Stocks |
| 0-20% | Bank Deposits |

- **Balanced Portfolio:** The primary objective is to earn a total rate of return which, over the long run, is in excess of short term interest rates available in the base currency. Current income is not a goal.

| | |
|---|---|
| 40-50% | Bonds |
| 40-50% | Stocks |
| 0-20% | Bank Deposits |

- **Stock Portfolio**: The primary objective is capital growth. This implies a willingness to assume a certain level of risk and income generation is not a goal.

| | |
|---|---|
| 80-100% | Stocks |
| 0-20% | Bank Deposits |

Over the long term, equities have been better investments for protecting against capital erosion by inflation. Since 1980, equity returns in the U.S. have averaged 11.7% in real terms. In the last 55 years, U.S. stocks have returned an average of 8% in real terms. In contrast, since 1980 the U.S. bond returns have been equivalent to 8.2% in real terms. However, taken over a longer period of time, the last 55 years, they only yielded an average of 0.3% in real terms.

*Benchmarks.* The performance of the portfolio should be evaluated using an internationally recognized standard. The components of the portfolio can also be broken down and examined vis-a-vis relevant measures. The standard international sources of comparison are:

- The Morgan Stanly Capital International World Index (for globally invested stocks)
- The Salomon World Government Bond Index

**Uganda MBIFCT Investment Strategy**

The investment goals of the trust are: adequate income, protection of real capital value, and a conservative strategy to maximize the long-term sustainablity of the project. Therefore, the following strategy was proposed:

- bonds for income (30-60%)
- stocks for protection against inflation (30-60%)
- a small amount of cash for liquidity(0-10%)

Bonds and stocks should be restricted to high-grade investments. Bonds should be AAA or AA+, and stocks should be in 'safe' markets.

*Source: Lloyd, R.G. 1993*

- The Barclays de Zoete Wedd Portfolio Management Limited (BZW) World Index (for level of inflation worldwide)
- Relevant performance of stocks and bond markets such as the Standard and Poor's 500 (S&P 500) for U.S. stocks or the Wilshire 5000.

### *Investment Philosophies*

Each investment bank has a unique investment philosophy by which it selects the individual stocks and bonds to place in the client's account. There is no hard and fast rule about which approach produces the most reliable results. The client should always understand the approach to investments used and feel comfortable with the general philosophy. The following outlines five basic applied approaches.

*For Stocks* -

- **Top Down** - The use of fundamental data (usually macro-economic) to make an initial allocation decision by country, then by economic sector, under a wide range of economic scenarios. (e.g. 50% to U.S. markets, 30% to European markets, and 20% to Asian markets) Once appropriate weighting have been identified, individual securities (stocks) are analyzed on a relative value basis and selections made, usually based upon the expected highest total rate of return and low performance volatility.
- **Bottom Up** - The focus on individual companies and sectors of the economy is primordial to the macro economic and market specific situation. The focus is on relative stock value and selection criteria (e.g. long-term earnings growth). Asset mix, country allocation, and economic sector allocation are well defined, but secondary criteria.

*Value Oriented Investing* - Either Top Down or Bottom Up is applied, but the actual stock selection criteria is focused on choosing companies which are undervalued relative to the industry in the market, using criteria such as price to earnings ratios.

*Quantitative Analysis* - The movements of the markets and individual stock prices are measured and analyzed to predict future performances. There is a wide variety of quantitative analysis available. It is common for qualitative methods (top up, bottom down) to apply some sort of quantitative analysis as a second filter for stocks and sometimes market selection.

*For Bonds* - There are basically two major concerns for bond allocation: currency fluctuations and interest rate movements. Quantitative and qualitative analysis can be applied to both. Interest rate expectations usually shape the lengths of matures of bond positions, for example, whether to hold a two, five or ten year bond. There are two ways to analyze currency fluctuations and interest rate movements.

*Separation of Currency/Interest Rates* - The two are subjected to separate fundamental analysis. Comparison of interest rate differentials between countries are assessed net of anticipated currency fluctuations to determine optimal country/currency allocations.

*Blended Analysis* - The two concerns are analyzed jointly to determine the optimal allocations. Quantitative analysis can also be applied.

### *Management Fees*

Management costs usually depend on the asset mix and size of the account. The larger the account, the lower the fees as a percentage of the account size. An account of 100% bonds will also usually have lower fees than a balanced or stock account. Some common annual fee structures include:

- management fees cover all transaction costs and range from 0.25% to 1% of assets;
- management fees as above plus all related commissions on trades in the portfolio are charged;

- management fees as above plus all related commissions on trades in the portfolio plus a fee for collection of interest income and dividends, and possibly for each transfer from the account;
- any of the above arrangements, with management fees linked to the performance of the portfolio.

Additionally, custodial fees for the safekeeping on the securities and cash, as well as their documentation and registration are charged by the bank which holds the assets. Custodial fees run between 0.05% to 0.15% of the assets. The custodian is almost always the same banking group as the asset manager, which keeps the custodial fees at the lower end of the scale.

Commissions on trades of securities or bonds are very difficult to estimate. The commissions depend upon:

- which stock exchange did the trade occur;
- which company physically traded the shares on the stock market floor.

Often banks must commission another broker to make the actual trade on the stock exchange floor. When this happens, commissions paid by the client are usually slightly higher to cover this additional cost.

A typical fee schedule, excluding commission expenses, may be as follows:

**Should the asset management fees be linked to performance?** Most asset managers charge a fixed fee, as outlined above. However, there is a growing trend for asset managers to link the fees charged to the performance of the client's portfolio. For example, if the annual return is 10%, the fee is higher than if it were 8%.

**The advantages:**

- there is a clear incentive for the asset manager to perform well;
- net returns are easy to estimate.

**The disadvantages:**

- performance incentive may prompt a more aggressive management style which can lead to higher risks (especially in difficult markets);
- managers are penalized in periods of overall poor market performance and rewarded in periods of high market performance, regardless of the "value added" of their services;

A compromise solution is to set performance goals below which a fixed fee is paid, above which an additional fee is paid. This fee structure can work well for aggressive stock portfolios. However, for portfolios with a large fixed income component, the realistic performance goals are difficult to establish and again may lead to undesired aggressive management.

In conclusion, the benefits of a performance ranked fee structure appear to outweigh the negative side-effects for long-term conservative portfolios.

| **Fee as % of Total Assets** | | | | |
|---|---|---|---|---|
| Account Size in US$ millions | 10 | 20 | 50 | 100 |
| Stock and Balanced Accounts | 0.875% | 0.75% | 0.56% | 0.47% |
| Bond and Deposit Accounts | 0.50% | 0.40% | 0.30% | 0.23% |

# Alternatives for Funds Under US$ 5 Million

This annex outlines two options for the asset management of "small" trust funds. Portfolios under US$ 5 million may wish to consider alternatives to individually managed portfolios. Although private firms can and will invest smaller accounts, the fee structure and limited diversification in the account may make commingled or mutual funds a more attractive alternate. There are two general options for this type of account:

- Selection and trading of mutual funds in a private sector account;
- Management by a multilateral agency in a commingled account.

For the first option, a portfolio manager can manage a mix of three or four mutual funds in one account to get the exact blend of diversification desired. Fees for this type of arrangement are usually rather low. Care must be taken to purchase mutual funds that are easily traded and for which commissions can be negotiated or waved. For information on mutual funds, see Section 7.6 of Chapter 7.

The following briefly outlines the current arrangements for the second option for management by UNDP and the World Bank. UNDP currently manages the US$ 9.5 million for the Bhutan Trust fund as a separate account. UNDP manages only two such funds, the other being a United Nations fund for small grants. The management of these funds is guided by the investment policy of UNDP, which restricts investments to top quality government debt and bank deposits. No commissions or fees are charged on placing funds. The World Bank manages well over 300 trust funds (although no GEF supported Trust Funds) and is currently reorganizing these funds to standardize and commingle as many of the individual funds as possible.

There are some disadvantages or draw-backs in using a multilateral agency such as the UNDP or World Bank as an asset manager. Current funds are managed with a short-term investment objective and the average duration of all investments can not be more than 48 months. Conservation trust funds, being created in perpetuity, may find it advantageous to maintain a portion of their assets in longer term investments which have higher returns. Funds managed by the World Bank also have investment limitations which suit that institution, but eliminate good investment possibilities for trusts with long term growth as an objective. In the Bank's case, limits investments to government guaranteed non-corporate debt and deposits. No investments are made in stocks or corporate. Also, the agencies' investment strategies are geared towards very large portfolios and may not be flexible enough to handle accounts as small as 5-10 million for individual investments.

The advantages relate to commingling the funds and negotiable management fees. Due to large size of investments, commissions are usually not paid on trades. If more funds are established and a commingled fund is allowed, returns to scale would allow for greater diversification and most likely a higher rate of return over the long run.

**TABLE 2: GEF-BANK PORTFOLIO DISTRIBUTION BY REGION, FY92-FY95**

| | FY92 | | | | FY93 | | | | FY94 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Region | No. of Proj. | % of Total | Commitment Value (US$M) | % of Total | No. of Proj. | % of Total | Commitment Value (US$M) | % of Total | No. of Proj. | % of Total | Commitment Value (US$M) | % of Total |
| Africa | 1 | 20 | 3.3 | 4.5 | 3 | 33.3 | 19.0 | 27.2 | - | - | - | - |
| East Asia | 1 | 20 | 30.0 | 41.0 | 1 | 11.1 | 9.5 | 13.6 | 5 | 29.4 | 72.2 | 52.4 |
| South Asia | 1 | 20 | 10.0 | 14.0 | 1 | 11.1 | 26.0 | 37.2 | - | - | - | - |
| Europe & Central Asia | 1 | 20 | 4.5 | 6.2 | 2 | 22.2 | 6.1 | 8.7 | 4 | 23.5 | 6.3 | 4.6 |
| Middle East & North Africa | - | - | - | - | 1 | 11.1 | 4.8 | 6.9 | 3 | 17.7 | 29.5 | 21.4 |
| Latin America & Caribbean | 1 | 20 | 25.0 | 34.3 | 1 | 11.1 | 4.5 | 6.4 | 5 | 29.4 | 29.8 | 21.6 |
| Global | - | - | - | - | - | - | - | - | - | - | - | - |
| Total | 5 | 100.0 | 72.8 | 100.0 | 9 | 100 | 69.9 | 100.0 | 17 | 100.0 | 137.8 | 100.0 |

| | FY95 | | | | FY96 | | | |
|---|---|---|---|---|---|---|---|---|
| Region | No. of Proj. | % of Total | Commitment Value (US$M) | % of Total | No. of Proj. | % of Total | Commitment Value (US$M) | % of Total |
| Africa | 4 | | 17.5 | | | | | |
| East Asia | 1 | | 17.9 | | | | | |
| South Asia | - | | - | | | | | |
| Europe & Central Asia | 4 | | 36.8 | | | | | |
| Middle East & North Africa | 2 | | 10.0 | | | | | |
| Latin America & Caribbean | 2 | | 17.5 | | | | | |
| Global | - | | - | - | | | | |
| Total | 13 | 100.0 | 99.7 | 100.0 | | | | |

# Other Financial Mechanisms: Debt-for-Nature Swaps and Social Funds

There are a few mechanisms to set up monies for long term funding of conservation projects or trust funds. This section gives a brief background on debt-for-nature swaps and Social Funds, both of which can be used to meet objectives similar to those of a conservation trust fund, despite some obvious differences.

## *Debt-for-Nature Swaps*

Proceeds from a debt-for-nature swap can be used to establish a large sum of local currency for conservation work. This mechanism leverages donors' funds and reduces hard-currency debt of a nation and can result in a sizable amount of either local currency, bonds, or other assets to be invested for environmental ends.

Debt-for-nature swaps originated from the idea that the developing world should be relieved of some of its debts if, as a quid pro quo, it pledges to implement various environmental protection measures. The concept recognizes that the debt crisis and the environmental problems in the developing world are inter-linked. The goal is to reduce hard-currency indebtedness of developing countries and make critical investments in the environment.

The execution of a debt swap can be seen as a four step process. First, the donor (usually an international NGO) negotiates with the government of the debtor country to establish a framework for the swap. Second, the donor purchases uncertain debt from the original creditor or on the secondary debt market, but pays only a fraction of the ordinal value of the debt. The donor is now the new title holder and can apply to convert the debt. Third, in accordance with the conditions negotiated with the government, the debt is converted into local currency or government bonds or other assets. Usually, the donor pays a levy of 10% to 30% to the debtor country's central bank, thus sharing the original discount with the government. And finally, the donor can use the funds to implement the intended conservation project.

One of the most serious obstacles is the risk of inflation and devaluation decreasing the real value of the local currency fund. Second, debt conversions are time consuming, complex and in many cases controversial transactions. The negotiations between the donor (who holds the debt) and the debtor government to establish the exchange rate for the debt can be sticky and lengthy. Third, if the money would have been donated in any case to environmental projects, the leverage effect of purchasing the debt on the secondary market may implicitly represent a benefit to the donor (or a forced subsidy). Fourth, the conversion of hard-currency debt into local currency will raise the money supply in that currency and may create an inflationary effect. Therefore, it may be preferable to convert debt into government bonds in the recipient country instead of cash. This may result in a lack of flexibility in the spending of the funds. Fifth, there is no legal means to ensure that the objectives of the debt-for-nature swap are met. This problem applies both to agreements negotiated directly with governments and to those made with local recipient organizations. Finally, there may be a shortage of debt on the secondary market. The secondary market is volatile and the volume is estimated to be only $40-50 million. Furthermore, there are only 20 countries whose debt are traded regularly.

### *Social Funds*

Social Investment Funds, or Socio-Economic Development Funds, are funds that seeks to improve the living conditions of the poor through financing small, grassroots development projects. The fund is generally disbursed as small grants or loans. Social funds are generally sinking funds which distribute the funds for five to seven years. To the extent that GEF supported trust funds are not limited to conservation area recurrent cost financing, but also include a community support component, there are valuable parallels to be drawn between social funds and conservation trust funds. The following briefly outlines some of the features of social funds which may also be common characteristics to "community support" components of conservation trust funds.

Social funds are demand driven; they neither identify nor directly implement projects, but respond to requests coming from communities, NGOs, and local government for support to alleviate the costs of economic reform or support development activities in the social sectors, rural development an the environment. While social funds work through government agencies, thereby strengthening institutions involved in the design and implementation of social projects and policy, communities generate project ideas. The social fund appraises the project, then supervises and evaluates its implementation. Social funds have funded mainly rehabilitation and/or construction of basic infrastructures. Key objectives are rapid implementation and support of institutions and individuals that usually have very limited access to government funds, such as NGOs. This is accomplished by distributing small amounts of funds and employing procurement and disbursement mechanisms which correspond with local level managerial capacities.

# Glossary

*Article of Incorporation:*
The articles are legal documents which establish an entity, either as a for profit or charitable entity. Some off-shore trust funds will require an article of incorporation for the domestic organization for which the trust fund has been established. The document usually outlines the scope of activities, management structure and relationship to the assets.

*Asset Allocation of Investments:*
Assets invested in an account will purchase various types of securities (bonds, stocks, deposits) in various markets all over the world. 'Asset allocation' refers to the distribution of those assets into the different types of securities, different markets and currencies.

*Board of Directors:*
Also referred to as Board of Trustees, Management Board, Executive Committee, etc. This body governs the trust fund.

*Bonds:*
The debt of corporations or governments sold in units (usually units of 1,000) on different stock exchanges in the world. Bonds usually pay annual interest payments (sometimes called the coupon). The face value of the bond is paid ('redeemed') to the holder of the bond upon its maturity.

*Equity:*
Equity, also know as common stocks, are rights to a certain portion of a company's earnings and assets which are traded on different stock markets. See stocks.

*By-laws:*
By-laws provide the operational guidelines and procedures for the trust, such as members' functions and responsibilities in relation to decision-making, administration, financial management including appointment and monitoring of the asset manager, financial reporting and auditing, review of documents and reports, legal responsibilities, as well as procedures for meetings including voting systems.

*Corpus of the Trust Fund:*
The trust assets. The original corpus may be enlarged by further donations to the trust fund.

*Dissolution Clause:*
A clause of the by-laws and/or trust deed outlining the actions to be taken with respect to the assets of the trust fund upon its closure.

*Foundation:*
A trust-like arrangement used in civil law countries where there is no legal setting for trust funds.

*Grant Agreement:*
The legal document which sets out the terms and conditions under which a grant is made by the grantor (e.g. the World Bank or other donor) to a recipient (e.g. the client government or trust).

*Grantor:*
The person or organization who makes a conveyance (grant) in legal form.

*Irrevocability:*
The inability of the settler to annul or revoke the trust income.

*Irrevocable trust:*
A trust which may not be revoked after its creation (see revocability).

*Liquidity:*
Liquidity of assets refers to the readiness of the investments to be available in cash form, either for withdrawal and disbursement or re-investment in another vehicle.

*Location of Assets:*
Locale where the assets are physically domiciled.

*Location of Trust Fund:*
The situs of the trust entity.

*Mutual Funds:*
Organizations which invest the pooled funds of many savers, thus obtaining economies of scale in investing and reducing risk by diversification. The client purchases units of the funds, which can be sold on the stock market or redeemed directly to the company. Mutual funds and their objectives are varied to meet a vast range of investment needs.

*Plowback:*
That portion of investment income returned to the corpus in order to maintain its value in real terms.

*Principal of fund:*
The assets of the trust fund. See corpus.

*Revocability:*
The ability of the settler to annul or revoke the trust instrument by taking back power provided to the trustees.

*Revocable trust:*
A trust in which the settler reserves the right to revoke.

*Revolving Fund:*
A revolving fund has new assets added each period (e.g. annually) to the fund. It disburses its existing funds and income in each period.

*Risk:*
The probability that actual future returns will be below expected returns.

*Securities:*
Securities is a collective term for stocks, bonds, and equities.

*Settler:*
The one who creates a trust; one who furnished the consideration for the creation of a trust, though in form the trust is (or can be) created by another.

*Sinking Fund:*
A fund which is designed to disburse its principle plus income earned, over a designated period of time.

*Stock:*
The subscribed capital of a company is called a share when it is divided into portions of uniform amount. These shares, or "stocks" are traded publicly and can be bought on stock exchanges. Some companies pay out dividends (cash or more stocks) to its shareholders. The owner of a stock (the stockholder) may having voting rights depending on the class of stock owned. The most typical classes are common stock and preferred stock which generally refer to the priority given over assets owned by the company and voting rights.

*Volatility:*
Wide fluctuations in the stock market prices of stocks, bonds, and other financial instruments.

*Withholding Tax:*
Governments often exact a tax on dividends, bond interest payments, and capital gains on securities which are registered in that country and/or traded there. Most often this tax is taken, or withheld, at source.

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