NORTHERN TRUST

DESIGNING A DYNAMIC SPENDING POLICY

ADAPTING YOUR SPENDING POLICY IN TIMES OF CRISIS

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The long list of ways COVID-19 has changed the world includes a shift in how organizations view their spending policies. While codifying a spending policy can help guard against poorly thought-out decisions and preserve the future of an organization, sometimes a crisis occurs that is truly out of the ordinary and an immediate response is necessary.

COMPONENTS OF A GOOD SPENDING POLICY

An organization's spending policy is the primary input when determining the required rate of return from its investment portfolio. As a result, the spending needs of an organization are closely tied to its investment decisions. When viewed together, sound spending and prudent investing can enable an organization to fulfill its mission.

Key factors in designing a spending policy include:

- Planned spending rate
  - This rate should be smoothed over an appropriate time horizon (12-20 quarters) to reduce the overall volatility of spending
- Projected contributions
- Projected operating cash flows (if applicable)
- Other periodic cash flows
- Inflation

SITUATIONS THAT MIGHT CAUSE A CHANGE IN SPENDING

Adhering to a spending policy indicates good governance by an organization's leaders. But when an unexpected event occurs, there may be an urgent need that requires additional spending. In our work with clients, some of the unexpected events which have forced a change in spending policy include:

- The loss of a key donor or funding source
- An increased need on the part of grantees or service recipients
- Structural changes in the funding model of the organization

As an example, the COVID-19 pandemic created a need for organizations to examine their spending policies. Many organizations saw operating expenses increase across the board due to personal protective equipment (PPE) for staff who were required to be in the office, as well as additional hardware for those working remotely. At the same time, the needs in the communities they served were increasing sharply.

THREE APPROACHES TO ADAPTING AN ORGANIZATION'S SPENDING POLICY

In the sections below, we present three different options for adapting a spending policy in times of crisis, and review the key considerations for each.

1. Permanent spending rate increase

An acute crisis may cause an organization to decide to raise its spending rate as a matter of policy. Several societal issues came to light as a result of the pandemic, leading certain organizations to commit to increased grant-making going forward.

We view any change to an organization's spending policy as a governance matter. As such, the board needs to carefully weigh the current needs against the long-term sustainability of any potential increases. In addition, understanding the characterization of your investment pool is extremely important. For those organizations with a high degree of restricted gifts, a permanent spending increase may be difficult to fulfill unless it aligns with the majority of donor intents.

The board should also consider the nature of the spending. Additional spending dedicated solely to operations may create an unhealthy dependence on the long-term funds for operational needs. However, increased spending for grant-making and support would likely be viewed positively by grantees and donors.

One disadvantage of a permanent spending increase is that it can be difficult to change and typically requires board approval. If future needs decline or the organization's finances come under pressure, it may require a change to your Investment Policy Statement (IPS). With future investment returns expected to be muted relative to the recent past, spending more today can potentially shrink a portfolio, resulting in an erosion of spending power and the value of the corpus over time.

2. Special distribution

During the pandemic, many organizations approved one-time distributions above the amount in their spending policy. A special distribution can be an effective response to an event such as a storm or flood. It gives organizations the flexibility to fund needs as they arise, without requiring a formalized change to their IPS.

However, approving a special distribution may open the door to this option becoming normalized – and potentially misused. Special distributions should not be used as a substitute for a consistent spending plan, nor to plug holes in an organization's operating budget.

In addition, a one-time distribution can create its own crisis if the organization liquidates investments at depressed prices to fund it. Taking additional funds from a declining asset base can create a downward spiral that may put the whole organization at risk.

CASE STUDY

A global organization dedicated to empowering women saw sharply increased needs during the pandemic. Many of its member organizations were having difficulty paying their dues, and the communities they served were struggling as well. The association maintains a spending policy of 5% of its corpus each year, but wanted to exceed that level for two purposes: (1) to waive or suspend dues payments from association members, and (2) to create a fund that member organizations could borrow from to fund their work at the local level.

The association approved a special distribution that would allow it to make grants to certain programs above and beyond the spending policy. Because the investment portfolio had grown over the prior few years, the organization was able to make extra draws without invading principal. In addition, the board decided to set up a line of credit, to be used to support member organizations that were unable to pay their dues. Ultimately, the association and the groups under its umbrella were able to weather the storm.

3. Credit as a distribution tool

There is a third option for meeting increased needs in times of crisis: accessing credit. Organizations can borrow against the value of their portfolio to create a collateralized line of credit. Or they can potentially borrow based on other assets or on an uncollateralized basis at a higher rate.

By borrowing to fund increased spending, an organization avoids the risk of selling securities at depressed prices. During the brief Corona Crash of 2020, when the stock market declined by nearly 40%, a sale of long-term assets would have been a potentially fatal error. Using credit as a distribution tool allows an organization's funds to continue compounding uninterrupted.

However, the key to this strategy is having a line of credit in place prior to a market downturn. Since the pandemic, many organizations have considered implementing an emergency line of credit which would allow them to draw upon those funds only if absolutely necessary.

When determining which route to take, organizations should compare the cost of borrowing to the expected return of the portfolio over the length of the loan. When interest rates are higher, the potential cost may be prohibitive. It is also important to consider how donors would view the organization's decision to take on debt. If it would not be well-received, then a different option for increasing spending may be more appropriate.

DETERMINING WHAT IS RIGHT FOR YOUR ORGANIZATION

The COVID-19 pandemic reframed spending for many organizations. While this brief overview offers a decision framework for considering changes to your organization's spending policy, there are oftentimes multiple factors at work. The advice of an experienced investment advisor can help your organization proceed with confidence.

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