Social Investing: Using Capital to Promote Foundation Goals

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Introduction

Whether the economy is expanding or declining, the prospects of employment for unskilled, marginal or disadvantaged people are likely to remain poor. The general hardships of unemployment are multiplied for young people who have no experience and limited education and for minorities who face discrimination. Without work and the status and feeling of purpose which work gives, people lose the sense of cohesion and identity which has traditionally arisen from a shared task or a shared place of work. New forms of community investment with distinctive economic objectives must be considered, not only for the relief of poverty, but for its prevention.

The donations of Canadian foundations have not been keeping pace with the almost exponential increase in the financial requirements of Canadian charitable organizations. In 1985, Canadian foundations disbursed $168 million from assets of $2.2 billion. This represents about five per cent of the total donations received by charitable organizations from individuals, corporations and foundations.[1] The percentage has remained stable and, given the current disbursement requirement, this figure is unlikely to rise.

Current disbursement policies for Canadian foundations usually lack originality. Grants are drawn from investment income and, in a few instances, the assignment of securities. In an effort to increase the resource base for its charities, the Laidlaw Foundation has begun to explore the creation of a social investment fund through the use of program-related investments (PRIs). The foundation believes such an alternative investment strategy will also assist charitable organizations to develop income-generating activities, build assets which will make them more self-reliant, and offset, in part, their dependency on grants and subsidies.

Program-Related Investments

PRIs can be made by the investor/foundation in at least four different forms:

- a loan to the recipient organization that the foundation wishes to support;

- a purchase of shares in the recipient organization;
- a guarantee of loans made to the recipient organization by commercial lenders; and
- an investment in intermediary organizations that, themselves, make PRIs.

PRIs offer the foundation additional ways of furthering its charitable purposes, i.e., it can invest its principal, accumulate the interest or dividends, and reinforce its benevolent impact by promoting social ends with further grants from this income. It is thus able to spend its money twice—once as principal and again as income.

PRIs can be used for many purposes. They may support community-based enterprises, create businesses owned by marginal or disadvantaged groups, construct housing and educational, cultural or recreational facilities, and foster urban and rural economic development. The idea is not new. More than 75 United States foundations and several life insurance companies have already established social or community investment funds. Almost all include the financial participation of insurance companies, banks, private foundations, etc.

Most investment funds operated by foundations are directed to social and economic investment in disadvantaged communities and generally accept two widely held myths about the poor and poverty:

1) The poor do not have large enough incomes.
On the contrary, John McKnight at Northwestern University, and others who have studied poverty, have argued for years that it results, not so much from a lack of resources or capabilities, as from patterns of ownership and control of land and housing and of businesses and financial institutions that drain the resources of lower-income communities. The problem is not that money does not flow *in,* but that it flows *through,* i.e., most of the land, housing and jobs in low-income communities is not owned or controlled by the people in those communities.

2) The poor are inherently bad credit risks.
Because of this belief, poverty is perpetuated by credit barriers and social divisions which deny lower-income communities access to the capital required to initiate community development, or the ability to retain and re-invest which would enable their people to build equity for the future. The credit gap denies low-income communities the opportunity to build credit records and open opportunities, since conventional lenders are generally unwilling to assume the risks they perceive in loans to low-income borrowers, e.g., the extra time required to service small loans and

unsophisticated borrowers and the greater risk of default, as well as the higher profits to be made in other segments of the market.

PRIs are based on the conviction that a major impediment to economic development in low-income and marginal communities is not these widely held misconceptions but simply the communities' inability to raise debt and equity capital.

Criteria for PRIs

A foundation with a PRI program must consider both traditional loan criteria and social criteria in making loan decisions. Traditional criteria include the technical capability of the applicant, provisions for technical assistance, the feasibility of the project, the adequacy of financial planning and the security available for the funds loaned/invested.

The social criteria might assign a high priority to community organizations and projects that address both immediate and long-term needs as well as:

- the degree of need and the number of people served by the project;
- the "multiplier impact" of being able to leverage financing from other institutions;
- the potential ability of the applicant to act as a catalyst for further projects;
- the inability of the applicant to obtain financing from other sources;
- terms of repayment which assure the affordability of the project for low-income people.

Loans to community groups are normally secured by real estate, mortgages or liens on equipment; some are secured by third-party guarantees.

Legal Considerations

The basic legal definition of charity was established in 1601: the relief of poverty, the advancement of education and religion, and other benefits to the general community.

In the United Kingdom the 1976 *Goodman Report on Charity Law and Voluntary Organizations* pointed out that while the relief of poverty has long been considered as a charitable activity, the prevention of poverty, i.e., setting up an enterprise on a non-profit-making basis so as to create opportunities for employment, was not. The fact that an organization would be non-profit- making except in the sense that it would have to pay its way, is immaterial. PRIs permit the foundation to avoid this legal restraint by operating through investments rather than through disbursements.

In the United States, the *Tax Reform Act* of 1969 provided legal recognition for PRIs, i.e., they now affect the calculation of the foundation's annual pay-out requirements because PRIs are not counted in the asset base against which payouts are calculated.[2]

In contrast, Canada does not, at present, provide a legal basis for PRIs and they may not be counted towards a foundation's annual payout requirements nor deducted from the asset base. Some legal experts also note that Canadian charitable organizations may be limited in the percentage of debt or equity they may hold in any corporation. (In Ontario the *Charities Accounting Act* R.S.O. 1980 c. 65 has this effect.)

In addition, the scope of foundation investments may be limited by the charter or trust deed that created the foundation. Trustees are bound to invest only in securities permitted to trustees by statute (see for example the *Trustee Act* R.S.O. 1980 c. 512 ss 26-32) or by their charters.

Some Common Concerns About Initiating A Social Investment Fund[3]

1) The endowment should only be used to earn the highest return.
It is true that a higher return can be used for more investments or grants and social investments are likely to hinder this goal. Put in colloquial terms, many foundation directors would say, "We invest to make money. We take our chances when we make grants".

Philosophically this position, which makes a sharp distinction between investments and grants, is difficult to rebut. On the operational level, however, a strong argument can be opposed. Although social investments or PRIs unquestionably involve risk, they also involve opportunity. They can meet both financial and program targets. (It should also be noted that it is not uncommon to see the "pure" investments fall far short of performance expectations.)

For purposes of financial accounting, social investments can be segregated in the foundation's statements as a separate category of investments. At Laidlaw, we have classified them as "charitable investments". Since the purpose of these investments differs from the purpose of our other investments, there is a rationale for accounting for them differently.

2) Using endowment funds to help generate income for others is inconsistent with foundation purposes.
The reduction of public expenditure for a variety of social programs requires charitable and non-profit organizations to develop a more diverse funding base. Foundations may limit their social investing to ventures

consistent with their general objects and still achieve the benefit of PRIs, i.e., the greater financial impact derived from using capital *and* income.

3) The foundation may not have the staff or expertise to assess the merits of social investment proposals or to manage projects.

This situation may be mitigated somewhat by participating in a co-operative assistance fund or purchasing services from a community development corporation or financial institution which performs the analytic, investment and monitoring tasks. In the United States, intermediary organizations like the Taconic Foundation have been established by several foundations and designed as tax-exempt organizations with the purpose of making PRIs from a pooled fund.

4) The social investment fund is too small to have an impact.

A survey conducted for the Ford Foundation in 1986 revealed that most of the more than 75 United States foundations and life insurance companies that have established PRIs have a capital base which varies in size from $100,000 to $250,000, with only a few exceeding $1 million, and their investments commonly fall in the $5,000 to $25,000 range. Even the smaller investments have generally been found to have had a significant impact since the start-up requirements for micro-enterprise initiatives are generally very small (under $5,000).

Why A Foundation Should Have A Social Investment Fund

1. When foundations make social investments or PRIs, the loan repayment, interest income, or dividends they receive can be recycled to other projects. This stretches philanthropic dollars further than they might normally go. Grants are given as gifts without the expectation of financial return. PRI dollars are capital and capital investments produce income whether socially or financially invested.
2. PRIs are often used to bring potential investors or lenders (private, public or philanthropic) into the proposed projects. This leverage greatly expands the total amount of potential funding available for social investment. Commercial institutions often require others to hold subordinated (therefore riskier) positions in an investment.
3. PRIs can be used where grantmaking is inappropriate. Investments can be made in non-profits and individuals not registered as charities, while grants must often be limited to organizations with legal status as charities.
4. Social investment funds expand the number of mechanisms available to a foundation to support an organization's programs.
5. Social investments can create a different kind of relationship from that which may normally exist between donor and recipient. For example,

while grants may induce a sense of dependency, investments promote a more businesslike relationship since investments usually involve tighter reporting and clearer monitoring from both foundations and recipients.

6. As one major foundation has put it: "The generation of revenue provides a measure of independence for the recipient. An organization that covers a percentage of its operating costs through earned income is in a better position to negotiate with funding sources and make long-term strategic plans than one wholly dependent on grants."[4]
7. "An income-generating venture may build an asset of long-term usefulness to the charitable non-profit organization, and thereby strengthen its capacity or pursue its program goals. This asset may be cash or real estate, or an intangible such as market position."[5]

Conclusion

Since program-related investments can greatly expand the resource pool available to the charities sector, I encouraged foundations to consider this option. As noted, current Canadian law does not facilitate social investing because the *Income Tax Act* does not permit the inclusion of PRIs in the minimum charitable disbursement requirements. Several charities and foundations, nevertheless, have begun to explore the potential of the PRI approach with the Economic Council of Canada, labour organizations, financial institutions and municipal governments. It is our belief that if the law now stands in the way of an investment strategy that should be promoted, then the law should be changed.[6]

FOOTNOTES

1. Robert Thompson, *Canada Gives: Trends and Attitudes Toward Charitable Giving and Volunteerism*, (Toronto: The Canadian Centre for Philanthropy, 1988), p. 43.
2. *Social Investing Through Program-Related Investments—A Report to the Ford Foundation*, (New York: New Ventures, 1984), p. 9.
3. Council on Foundations, *Program-Related Investments: A Primer*, (Washington: Resources for Grantmakers Series, Piton Foundation, 1986).
4. *Program-Related Investments: Review Paper*, (New York: Ford Foundation, September, 1986), p. 4.
5. *Ibid.*
6. Readers seeking further information about PRIs are invited to get in touch with the author at the Laidlaw Foundation, Suite 203, 60 St. Clair Avenue East, Toronto M4T 1N5.