Response to call for written evidence: further evidence

House of Lords Select Committee on Charities

The Association of Charitable Foundations

October 2016

1. **Association of Charitable Foundations** (ACF) is the membership association for foundations and charitable grant-making trusts in the United Kingdom. ACF's priorities include enabling trusts and foundations to achieve good practice in grant-making and helping them to be effective in the many ways that they use their resources, including their investments for charitable purposes.

Summary

2. **Charitable foundations provide nearly 10% of UK charity sector income through their grant-making. In turn, 70% of charitable foundations rely on investment income to fuel their activity. These 'endowments' constitute an enduring asset for civil society, with trustees obliged to use them and the returns they produce solely for their charitable objectives. The Charity Commission and other UK regulators hold trustees to account for what they spend, but only trustees can decide on how much to devote year on year to achieve their charitable objectives and over what timescale.**

3. **Typically foundations spend between 3 - 4% of the portfolio's value each year. A mandatory payout rate however could have a negative impact on foundations' spending power in the long-term. For example, evidence shows that too high a rate could permanently erode some endowments, forcing charities out of business within a generation. Too low a rate might decrease the ambition of current high spenders. In addition, a strict spending rate could prevent foundations from using their endowments creatively – say for social investment. There can therefore be no 'one size fits all' solution. Charity trustees should independently decide what is best in their circumstances.**

How charities are financed

4. While most charities support their work through a combination of fundraising, donations, appeals, membership fees or earned income from their work or services, £3.8bn, nearly 10%, of income to UK charities, comes through grants from trusts and foundations[1]. Among trusts and foundations themselves, 70% rely upon income from investments to provide the funds they

[1] NCVO Almanac records that UK charities received £3.8bn in grants from foundations out of a total income of £43.8bn. Available at: https://data.ncvo.org.uk/a/almanac16

disburse in support of their charitable aims[2].

What is a charitable endowment?

5. One of the notable successes of such 'charitable endowments', as these investments are often known, is that donations that have been invested by trustees have enabled charities to continue doing good across generations and in some cases for centuries. For example Cripplegate Foundation, established in 1500, still gives grants of £2m each year to the most disadvantaged in Islington, including £500k from its historic endowment valued at £34m, because their longevity and experience gives confidence to today's donors. Foundation endowments are therefore an enduring source of support for civil society, and trustees must use both the underlying investments and the revenue they produce entirely for the charity's mission. Careful stewardship of endowments allows foundations, many of which have existed for hundreds of years, to take risks, offer long-term support and back causes that otherwise may struggle to gain attention.

6. Cripplegate's endowment is permanent, meaning that trustees must only spend the investment income each year thus preserving the capital across generations. However, unless the trust deed states explicitly that endowments are to be held in perpetuity, trustees of charitable endowments have discretion to manage them in ways that best meet their charitable objectives. For some, this may means 'spending out' the endowment within a specific time period. Other boards may judge that their endowment constitutes a unique asset for their cause or beneficiary group and will aim to manage the charity's investments to enable them to go on doing good into the foreseeable future, often by striking an equitable balance of spending between generations.

7. Whatever their aim, trustees are obliged to use their endowment and all its income solely to advance their charitable aims, and they must therefore be prudent stewards of their charity's endowment – not least in choosing the right spending rate.

Is there an appropriate spending rate for all foundations?

8. Research carried out by ACF in 2013 revealed that charities relying on investment returns to fund their activity over the long-term adopted a range of spending rates, with the most frequent approach being to spend between 3-4% of the value of the portfolio each year[3]. While some charities spent lower, many charities – most notably older, larger charities – spent above this rate.

9. The research also revealed that even apparently modest adjustments on spending rates can have a dramatic impact on the trust's funding base, so that higher spending rates can draw heavily on an endowment over time, greatly increasing the probability that it will be completely eroded. [See Figure 1] For example, the analysis shows that a spending rate of 4% could substantially increase the probability of permanent reductions in the portfolio size – and therefore spending power – of an organisation to just 32% over 30 years, compared with a 52% risk of seeing it shrink if spending were set at 3% per annum over the same period. Nonetheless, the report concluded that in many cases, if trustees felt it appropriate, it could be right for them to take an 'open ended' approach to the trust's longevity rather than always aiming for preservation.

10. Trustees therefore have careful decisions to make, and must take them in light of their particular context. Preservation of the endowment can never be an end in itself, and can only be pursued if it serves the charitable purposes.

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[2] of 220 sampled in Jenkins, R. & Rogers, K. (2013) *For Good and Not for Keeps*, London: ACF, p.34

[3] Jenkins, R. & Rogers, K. (2013) *For Good and Not for Keeps*, London: ACF, p.4

Probability of maintaining real value

Expenditure	No Spending	1% p.a.	2% p.a	3% p.a.	4% p.a.	5% p.a.
Forecasts: Schroders' 30 Year Forecasts	94%	86%	72%	52%	32%	16%
History: Example portfolio (Rolling 30 years)	100%	100%	100%	93%	77%	58%
History: Example portfolio (Rolling 10 years)	88%	80%	70%	58%	53%	50%
History: Peer group (Rolling 10 Years)	92%	83%	68%	62%	47%	17%

Forecasts and estimates constitute our judgement at the time of issue and are subject to change without notice.

Past performance is not a guide to future performance

[18] Source: Schroders. Data courtesy of Elroy Dimson, Paul Marsh and Mike Staunton, Triumph of the Optimists: 101 Years of Global Investment Returns, Princeton University Press, 2002; and WM. Example portfolio: 80% UK Equities, 15% UK Bonds, 5% Cash from 1899 to 2011, Peer Group: WM Total Charity Universe total return since 1984.

Forecast returns based on an asset allocation of 80% UK Equities, 15% UK Bonds and 5% Cash and Schroders' 30 year asset class and inflation forecasts. Please see Appendix i. If you would like to calculate your own portfolio's expected return and sustainable expenditure rate then please visit www.schroderscharities.com/spendingdecisions. Probability based on an annual expenditure and a normal distribution of returns.

Historical analysis based on the total return of the example portfolio over rolling 10 and 30 year time periods and the total return of the peer group over rolling 10 year time periods at different annual spending rates.

Figure 1: Probability of maintaining real value

What about a mandatory payout rate?

11. It is therefore possible to see the effect of imposing an inappropriately high mandatory payout rate on charitable endowments, especially in today's 'low-return' investment environment. The above modeling on the impact of different rates on the value of an endowment, and therefore a charity's spending power, shows that enforcing too high a mandatory spending rate could put many funders out of business in a generation, particularly when faced with volatile markets that can see the value of the endowment rise and fall dramatically. While for some funders 'spending out' may be the right thing to do, for others it would fetter their independence in balancing the needs of today's generation with those of the future.

12. The largest grant-makers that rely on investment returns to fund their activity generally spend at a fairly high rate – an average of over 4%[4] - perhaps due to the greater confidence their resources give them in weathering economic storms (e.g. after the credit crunch 85% of funders maintained or even raised their spending rates, despite falling equity returns[5]). A mandatory rate that was therefore set too low could cause these trustee boards to reduce their spending. As 20 large foundations account for half of all grant-making from the sector[6], just a few foundations reducing their spend rates could noticeably deflate the overall grant spend, even if much smaller foundations simultaneously increased theirs. In addition, a mandatory fixed spending rate could limit trustees' discretion to use their endowments creatively – for example using part of it to make social investments.

13. While a 5% payout 'rule' exists in the United States[7], it is not possible to draw comparisons between the US and UK sectors. The US context is very different - with more new donors than here in the UK putting money into foundations, enabling a seemingly higher spending rate, as well as much more expansive allowances around what counts as charitable spend. It is also worth

[4] Jenkins, R. & Rogers, K. (2013) *For Good and Not for Keeps*, London: ACF, p.35
[5] Jenkins, R. & Rogers, K. (2013) *For Good and Not for Keeps*, London: ACF, p.4
[6] Pharoah, C., Jenkins, R., Goddard, K. & Walker, C. (2016) *Giving Trends 2016*, London: ACF/CGAP@Cass/Pears Foundation, p.4
[7] United States Inland Revenue Service (1999) *Part 7. Rulings and Agreements / Chapter 27. Exempt Organizations Tax Manual / Section 16. Taxes on Foundation Failure to Distribute Income / Statute* Available at: https://www.irs.gov/irm/part7/irm_07-027-016.html

noting that Canada has a mandatory payout rate of 3.5%[8].

Are foundations accountable and regulated for what they spend?

14. In a word, yes. Unlike the US, the UK has specialist charity regulators which have the know-how to challenge endowed charities on spending rates based on a context specific judgement call. The current regulatory regime only allows trustees to add to the capital value of the endowment if they have good reason to do so and can justify this, and we know that the Charity Commission has challenged endowed charities about spending rates in the past and continues to do so.

Conclusion

15. Any mandatory rate inevitably neglects the importance of individual charitable mission, organisations' attitude to longevity and changing market conditions. A one-size-fits-all approach is unlikely to have a net positive effect on spend over the long term, and in the process would risk hampering foundations in their mission to use their resources in the service of supporting others, whether by preserving social good that is under threat or catalysing it where it is absent. Only trustees can decide how best to use their resources, and their independence to do so must be preserved. The current regulatory system already holds them to account.

[8] Canada Revenue Agency (2016) *Disbursement quota calculation*
Available at: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/spndng/clclb-eng.html