Useful Guidelines - Charities and social investment

Introduction

1. One way in which charities may pursue their charitable purposes is through the provision of loans, loan guarantees or the subscription or purchase of shares or through the letting of land and buildings. These methods of carrying out the objects of a charity are referred to in this guidance as ‘social investments’. Social investments may generate a financial return, but the charity’s main objective in making them is to help its beneficiaries.

2. Such activity is sometimes called ‘programme related investment’ or PRI. This phrase emphasises the link between the pursuit of a charitable purpose and the loan or share subscription or purchase, or the letting of land and buildings.

3. Social investment is not ‘investment’ in the conventional sense of a financial investment. Conventional investments involve the acquisition of an asset with the sole aim of financial return which will be applied to the charity’s objects. Social investments, by contrast, are made directly in pursuit of the organisation’s charitable purposes. Although they can generate some financial return, the primary motivation for making them is not financial but the actual furtherance of the charity’s objects. The normal rules on financial investments for example, in the Trustee Act 2000 therefore do not apply.

<table>
<thead>
<tr>
<th>The difference between social investment and ethical or socially responsible investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social investment is primarily, if not exclusively, concerned with furthering the objects of a charity. It is not the same thing as ethical, or socially responsible investment. Ethical, or socially responsible, investment is investment in the ordinary, financial sense, but recognising that:</td>
</tr>
<tr>
<td>i) a charity cannot be expected to select investments which are in obvious contradiction of its mission;</td>
</tr>
<tr>
<td>ii) a charity can discriminate against, or in favour of, a particular investment or class of investment, if its trustees reasonably believe that it is in the charity's best interests to do so (eg in order to avoid donor alienation). If this discrimination involves the risk of significant economic detriment to the charity, the trustees need to be sure that donor alienation presents a more serious economic risk.</td>
</tr>
</tbody>
</table>

Box 1

4. Many charities already make social investments. Although often associated with economic development, regeneration and/or the relief of poverty or unemployment, social investment can be used to promote any charitable purpose. Sometimes large sums are invested enabling the development of complex high-profile projects. In other instances relatively small sums of money are made available for straightforward
purposes such as the purchase of new equipment or the renovation of premises. Sometimes loans will be provided alongside grants.

5. There is almost certainly scope for more charities to engage in social investment if their trustees wish. If handled well, social investment can increase the help a charity can offer in the short to medium term; it enables funds to be recycled so that a greater number of projects can be supported. These guidelines have been produced to help those charities considering making social investments.

Making social investments

Developing a policy

6. Any charity that can give grants can provide support in other ways (eg by making loans, by purchasing or subscribing for shares, or by letting land and buildings) unless it is specifically prohibited in the charity’s governing document. Trustees will need to check that social investment is both a legitimate and (in the circumstances) a reasonable way of furthering their charitable purposes. The key question for trustees is whether social investment offers a good means of advancing all or some of the charity’s objects.

7. Trustees engaging in social investment would be expected to have a clearly articulated policy for this form of support. This policy should for example, explain why the charity engages in social investment activity (fit with organisational mission) and how it engages (fit with organisational strategy). It should for example, set out the charity’s general approach to returns.

8. Some charities might favour a policy of support for projects promising a good return on the basis that greater benefit will be delivered through the recycling of funds. Others might choose instead to support projects with less certain prospects because they are innovative and if proven effective will deliver significant social benefits. Others might decide to achieve a balance between these two different types of projects.

9. In the interests of transparency the charity’s annual report should spell out its social investment policy and contain a statement about how it has been applied during the year. Further guidance on how social investments should be dealt with in accounts will follow and will be attached to this guidance as an annex.

Duty of care

10. The same duty of care applies to social investments as to grants. Trustees have the same basic responsibility to pursue the charity’s objects considering all relevant matters and seeking independent professional advice when appropriate.

11. Charities with a record of social investment are unlikely to require independent advice on each individual decision (apart from those which raise novel or particularly complex legal or financial issues or where some other particular professional evaluation is called for). Many well established grant making charities have professional staff experienced in assessing projects and such staff may have the
necessary skills to make recommendations for social investment within the constraints of a robust policy framework.

12. However, social investment will be a novel area for many charities. They may be unsure of their ground initially. They may, for example, feel that they lack expertise in determining an appropriate level of return for a loan, or in assessing the prospects of a business, in economic terms, and in terms of the delivery of the charity’s objectives when they are considering subscribing for or purchasing shares. They may, therefore, consider it appropriate to seek independent professional advice until they have the experience necessary to develop and effectively implement a robust policy.

13. It is often argued that providing loans is less ‘risky’ than providing grants because loans are repaid whereas grants offer no return. But a charity will know from the outset that the outright grant will never come back, and can plan accordingly. It should be recognised that social investment does present risks that trustees need to consider.

i) For most charities social investment is likely to form only a small part of a wider programme. Here the major risk may be reputational. A high default rate when the stated policy includes generating a reasonable level of return might, for example, be taken to suggest that the investing charity had poor assessment or support systems in place.

ii) For a few charities social investment will be their primary activity (see Box 2). In these instances the viability of the organisation may be threatened if predicted levels of return are not achieved.

Charities which are new to this area might want to initially get professional advice to assist them set up the best assessment framework.

14. Trustees should have a clear understanding of how they are going to manage the relationship including how they are going to manage their exit from it. In other words, they need to understand the precise purpose for which a loan is made, the terms on which it is made, how its use is going to be monitored and when it is to be repaid. (Loan terms are discussed in Box 3). Exiting from a share holding relationship is obviously more complex (see example B and paragraph 19).
Social Investment and Charitable Objectives

Some charities specialise in social investment or the provision of financial support to organisations to help them to start up or to grow. The activity could fall within a range of charitable objectives including the relief of poverty, relief of unemployment, the regeneration of disadvantaged areas and community capacity building.

Many charities working to relieve unemployment concentrate their efforts on people without work. However, support for the casually employed or those in low paid work, including the provision of finance for business start-ups, can also assist in addressing unemployment over the longer term. It helps people to improve their career prospects and increases the likelihood that they will retain work.

Providing finance to existing as well as new businesses can advance the charitable purpose of relief of unemployment. It enables businesses to expand and take on additional workers thus reducing unemployment in disadvantaged areas. The provision of advice to existing as well as new businesses can also relieve unemployment.

More information can be found in our publications:

RR2 Promotion of Urban and Rural Regeneration
RR3 Charities for the Relief of Unemployment
RR5 The Promotion of Community Capacity Building

Social investment can also be a way of achieving more specific charitable objectives where the organisation invested in addresses other needs such as the provision of recreational facilities for disabled people or the protection and conservation of the environment

In future more charities may decide to become specialists in social investment. They may become intermediaries, financing other charities and non-charitable businesses. Some may gain accreditation as ‘community development finance institutions’ (see Box 4). Other charities may set up separate companies to engage in the activity which may or may not seek and gain accreditation.
Loan terms

Depending on the circumstances of the case an appropriate rate of interest might range between zero and the market rate.

It is legitimate for charities to try and ensure that their loans, while generally provided at below market rates of interest, are not simply low interest loans provided without proper regard to the rate that the borrower might be able and willing to pay. (In some cases a loan above a commercial bank’s base rate could still be at a significantly lower rate than would otherwise be available).

However, when setting the rate, charities should consider the impact on the organisation and its work. A zero or very low rate might be justified because the saving will enable the borrower to achieve greater charitable benefits.

Borrowers may be seeking a loan on the basis that they will start repayments only after a significant period has elapsed. This type of flexibility will be as important to many borrowers as the interest rate.

In some instances grants may be provided alongside loans. These grants might for example, help the organisation build its management capacity thus helping to ensure loan repayment.

Support for non-charities

15. Charities can normally make grants to non-charities, provided that the grants are made for purposes which further their own objects. This means that charities can also make social investments in non-charities, including commercial organisations, provided that there is a proper connection with the furtherance of their own objects. When supporting non-charities, trustees have the responsibilities set out in the following paragraphs.

16. When considering support for a non-charitable organisation, trustees need to assure themselves that

i) the money or other resource provided will be used to advance their charitable objects;

ii) that any private benefit derived from the grant or social investment will be purely incidental (it arises as a necessary but incidental consequence of a decision by the charity trustees to further their charitable purposes); and

iii) that any private benefit is not excessive and will be heavily outweighed by public benefit.

In some cases the assessment required will be relatively simple, in others it will be complex, based on multiple factors, and the decision will be finely balanced. There is no simple formula that trustees can use. They have a responsibility to take into account all considerations relevant to a particular case and to come to a reasonable decision on the basis of the evidence.
In assessing the public benefit under iii) above trustees might consider the expected return from the social investment, including the value of being able to recycle the money, in their assessment of the project’s wider public benefit.

17. After making the social investment, trustees will need to monitor the use which the investee makes of the resources which they have provided in order to ensure that they are being used to further the objects of the charity.

Example A

Many loans are requested for particular purposes. For example, a commercial organisation providing vocational training requests a loan to enable it to provide training facilities for the unemployed in a disadvantaged area. These new facilities will enable the company to train fifty local unemployed people each year under a local authority contract. A local charity set up to relieve unemployment considers making the loan on the basis that it constitutes the best use it can make of available funds.

The contract offered by the local authority enables the commercial organisation to cover costs and make a small margin. However, this margin is not sufficient to support a loan at market rates. It needs this loan to develop and equip training premises. It would not operate in the disadvantaged area without the charity’s loan which is offered at below market rates.

This sort of evidence of market failure to deliver employment, goods or services to disadvantaged people will often be the basis for justifying social investment in non-charitable organisations. The loan provided by the charity may make an indirect contribution to the company’s profitability. The company may for example, win more contracts of this kind with larger margins. However, trustees agree the loan on the basis that private benefit is incidental. Also, the ‘private benefit’ is reasonable in the circumstances; in this case it will be heavily outweighed by the public benefit to be derived from the training.

Example B

The social investment in example A is made for a specific purpose. But this does not mean that charities cannot provide general loans to or purchase shares in commercial organisations. The key question is the match between the charity’s objects and the general activities of the non-charitable organisation. A charity set up to help people with disabilities find employment might for example, choose to purchase shares in a commercial organisation run by and only employing people with disabilities.

The success of the company will deliver benefits to shareholders. However, these private benefits are incidental and will be heavily outweighed by the public benefit deriving from the investment (so long as the company’s employment policy remains unchanged). The more successful the company the more people with disabilities it is able to employ and train.
18. Trustees have a duty to secure charitable assets for application to charitable purposes. This means that in example A, the loan should be made on the basis that it will be used by the commercial organisation only to provide vocational training in a disadvantaged area. The terms should allow for the loan to be ‘called in’ should the commercial organisation stop providing vocational training for local people (see paragraphs 22 to 25 below). In order to obtain leverage trustees should also consider securing loans against the property or other assets of the organisations in which they make social investments.

19. In example B trustees should carefully consider at the outset what their exit strategy will be if the commercial organisation changes its employment policy. One option might be for the charity to secure a contractual undertaking from the commercial organisation to purchase the charity’s shares at an independently agreed valuation (again see paragraphs 22 to 25 below).

**Use of intermediaries**

20. Some charities specialise in social investment and more may do so in the future (see Box 2). However, relatively few grant making or service providing charities are likely to wish to develop significant loan programmes or to pursue social investment through share purchase or subscription. They may not have the relevant skills in their current staff team or they may be unwilling to allocate funds to buy them in. Or regardless of whether they have these skills in-house or funds to recruit them trustees may decide instead to support specialist intermediaries.

Example C below illustrates that this support may take the form of grants in addition to or as well as loans or other forms of social investment.

### Example C

A grant maker with general charitable purposes might make a significant grant to a charity loan fund financing social businesses. The fund’s objective might be to finance innovative social projects unable to access bank loans. The grant might double the value of loans and loan guarantees provided each year. Given that the fund might seek to recycle each loan as many as five times the grant will have a considerable impact on the number of social projects supported.

### Example D

A grant making charity set up to relieve poverty in a disadvantaged area might provide a loan to a local development trust. The loan might provide the start up capital needed for the venture. The development trust provides loans to local unemployed or under-employed people enabling them to set up their own businesses.
Example E

An operating charity which aims to meet the needs of older people might subscribe for or purchase shares in a loan fund set up to finance businesses started by the over 50s. It might make such an investment on the basis that unemployment is a major difficulty for this age group. There is also some evidence of age discrimination when they seek employment.

21. Trustees considering supporting specialist intermediaries through the provision of grants, loans, loan guarantees or the subscription or purchase of shares or the letting of land and buildings need to consider the range of issues set out in these guidelines. They need to be assured that:

i) They have the power to make a grant or loan or to subscribe for or purchase shares, or to let the land and buildings. Those able to make grants can make loans or other forms of social investment, provided it is not expressly ruled out in their constitution.

ii) The grant or loan or subscription for or purchase of shares or letting is considered the best or best equal means of achieving one or more of their objects.

iii) They have considered all relevant matters and have taken independent professional advice as appropriate.

iv) If the intermediary supported is non-charitable, the private benefit derived from the support is incidental and heavily outweighed by the public benefit (see Box 4).

Premature Exit Machinery

22. “Premature exit machinery” means the arrangements which a charity makes to ensure that it is not locked into a social investment which has, for some reason, ceased to make a contribution to the furtherance of its charitable purposes. This is likely to arise where the investee makes a significant change to the nature of its activities: the need for such machinery is obviously more likely where the investee is not itself a charity.

23. Where the social investment takes the form of a loan directly from the charity to the investee, or a letting of land and buildings, the premature exit machinery is likely to take the form of a condition requiring immediate repayment of the loan/termination of the letting, or the conversion of the loan/letting to commercial terms. The position is more complicated where the social investment takes the form of share subscription or purchase, because of the requirements of company law concerning the reduction of the capital of companies. Nevertheless it is possible for a company to agree conditionally to purchase its own shares, and to issue shares which are redeemable in certain circumstances. Such arrangements may provide suitable premature exit machinery for social investments which take the form of share subscription or purchase.
24. These are not necessarily the only forms of premature exit machinery which may be adopted.

25. Where the social investment is made through an intermediary the formulation of premature exit machinery may be complicated by the intermediary’s relationship with the ultimate investees. The principle that the social investment needs to have a continuing connection with the furtherance of the investor charity’s purposes remains a valid one. But practical considerations may limit the intermediary’s ability to agree fully adequate premature exit machinery with its charitable investors. In such a case the risk that the charity will be locked into a social investment which has lost any connection with the furtherance of the charity’s purposes is a factor which needs to be considered at the time when the investment is being proposed. But trustees may decide that, where the risk is small, the benefit to be obtained by making the investment justifies taking that risk.

---

**Accredited Community Development Finance Institutions (CDFIs)**

A scheme has been established by the Finance Act 2002 for the accreditation of organisations providing finance to businesses operating in disadvantaged areas or providing finance to enable groups currently disadvantaged in the labour market to establish businesses. Some accredited Community Development Finance Institutions (CDFIs) will have charitable status. Others will be non-charitable.

Individuals and (non-charitable) companies investing in accredited CDFIs will be eligible for tax relief up to twenty-five per cent of the sum invested over a period of 5 years. There is no financial incentive for charities to invest in accredited CDFIs.

However, to be eligible for accreditation official guidance indicates that CDFIs will be required to demonstrate that the businesses in which they invest ‘interact with the local economy to a meaningful degree’ and ‘present a significant benefit to the local community’. They will generally be responding to a market failure in the provision of jobs, childcare or other services. Accreditation will thus indicate that CDFI’s are delivering significant social benefit.

The obligations of a CDFI which are the result of accreditation only apply to the use by the CDFI of “qualifying investments” ie investments which attract tax relief. If a charity makes a social investment in an accredited CDFI, that will be a non-qualifying investment. However, a non-charitable CDFI may be able to assure a charitable social investor that it will treat its social investment in just the same way as it would a qualifying investment. If it does so, this will provide evidence to trustees that private benefit is incidental and heavily outweighed by public benefit.

A charity considering making a social investment in a CDFI whether or not it is charitable and whether or not it is accredited must still consider whether the activities which they are supporting will further the purposes of the charity.
### The funds available for social investment

26. Charities can make social investments from any resources which are available for application for the charity’s purposes. That means the charity’s income (and reserves) and the charity’s expendable endowment. Charities can finance social investment from reserves built up from income provided this still leaves reserves which meet the charity’s needs as set out in its reserves policy.

27. Many charities already have more calls on their income than they can regularly meet. In practice this provides a disincentive for many to engage in social investment regardless of the contribution that it could make to pursuit of charitable purposes. However, provided the charity has appropriate powers, trustees can, if they wish, use some of the charity’s expendable endowment to make social investments.

28. Permanent endowment is held on trust for investment in the financial sense and cannot itself be used to make social investments. As explained in box 1, that does not, of course, mean that trustees are unable to to take account of ethical/socially responsible investment considerations when investing permanent endowment. And trustees can, of course, use part or all of the income from the endowment to make social investments. (Box 5 also explains the relationship between social investment and the Charity Commission’s policy on total return.)

29. The corporate property of a charitable company is available for social investment within the charity’s objects. The comments made in paragraphs 26 to 28 apply to property which charitable companies hold on trust.

<table>
<thead>
<tr>
<th>Relationship with the Charity Commission’s total return policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trustees managing permanent endowments can ask the Charity Commission for permission to adopt a total return approach. This means that part of the capital growth on the endowment can be allocated to their income fund for application to charitable purposes. In considering this allocation trustees have to take into account and balance the needs of present and future beneficiaries. Trustees might use all or part of this income allocation for subsequent social investment.</td>
</tr>
</tbody>
</table>

Box 5