

## **FUNDING COMMISSION**

### **Paper 1– Capitalisation and Social Investment – Findings and Emerging Recommendations**

Between June and September 2010 the Commission published eight papers on its website on different aspects of its work. Comments were invited on these papers. The emerging recommendations in the papers have subsequently been amended as the Commission’s thinking developed. However, the findings in the papers contain much of the evidence on which the final report is based. Details of all those consulted during the preparation of the papers are given in Annexe 2 of the main report.

This is a revised (August 2010) version of the first paper published by the Commission on Capitalisation and Social Investment in June 2010.

#### **1. The need for capital**

*‘£1 of unrestricted funding is worth £10 of project funding’<sup>1</sup>*

Although many civil society organisations (CSOs) are adept at squeezing out 15% contributions to core costs from their project grants, as part of full cost recovery, a continuing issue for most of them is a lack of access to capital, or unrestricted funds, that they can use to invest in their organisation to build capacity; develop new products and services; or cope with unexpected events. Some grant makers, like Capacitybuilders, a few trusts and foundations and even fewer public sector agencies will fund capacity building directly, but this is very much the exception. Most organisations find it difficult to raise capital; build reserves or generate a surplus from fees, contracts or grants.

For the sector as a whole, it is apparent that income and expenditure are very closely matched: in 2007/08 charities’ expenditure amounted to 93% of their total income. Where this income is from the public sector, this situation can perpetuate dependency on government funding and makes organisations more vulnerable to changing policies and priorities. The close equivalence of income and expenditure is a reflection of the financial model underpinning most civil society activity.

As Clara Miller has argued<sup>2</sup>, CSOs operate in a ‘strange and often contradictory world’ where the normal rules of doing business do not apply. In the private sector, businesses charge consumers a price that:

- covers the cost of developing as well as delivering a service or product;
- enables the company to invest in its future growth and productivity; and
- pays a dividend to owners or shareholders.

In contrast, CSOs usually have to secure funding from third parties (donors or government funders) on the basis of cost, rather than price. In practice, the emphasis on funding projects rather than organisations means that most find it difficult to raise sufficient revenue to cover the full cost of running a service, let alone generate a surplus. As Miller notes, ‘the non-profit provider is left with the difficult task of finding

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<sup>1</sup> Quote from client of NCVO’s Sustainable Funding Team

<sup>2</sup> C Miller, *The Looking-Glass World of Non-profit Money: managing in for-profits shadow*

additional subsidy, turning proffered money away or providing under-capitalised services to clients, with eventual decline in quality’.

This can mean that organisations become preoccupied with sustaining existing activity, rather than focusing on their impact. As a 2007 study for the Office of the Third Sector found:

‘... the majority of [organisations] are in the position of focusing continually on organisational survival, sometimes necessitating some mission drift, and certainly in many cases at the expense of concentrating on the future development of the organisation.’<sup>3</sup>

By not being able to build the capacity of their organisation, CSOs are less able to innovate or withstand change. In the private sector, investment in infrastructure is part of the normal cost of doing business, necessary for long term efficiency and profitability. CSOs, on the other hand, can often find themselves being criticised for spending money on ‘administration’, or for having reserves in the bank, by donors and funders who want to see their money going directly to beneficiaries.

Obviously there is a balance to be struck between investing in organisational development and the direct costs of providing programmes and services. However, the sector is still a long way from finding the optimum point. This is partly because these two are seen by some as conflicting, rather than complementary functions and partly because there is too great a reliance on funding restricted for the direct work of the organisation. This is unsustainable in the long term. CSOs need access to unrestricted capital to maximise their impact and enable them to further their mission more efficiently and effectively.

#### *Reserves*

The need to strike the right balance between capital and revenue funding can be seen most clearly in relation to the amount of reserves an organisation holds. As the Charity Commission has stated: ‘Reserve levels that are set too high tie up money that could, or should be spent on charitable activity. If they are too low, the future of the charity may be put at risk’<sup>4</sup>.

The public (and some funders) are suspicious of charities that appear to ‘hoard’ reserves, rather than spend their money directly on beneficiaries. Yet if organisations themselves are not clear about why they need reserves or how much they need, they will be unable to allay fears that they are not using their money wisely. Every organisation needs to understand *why* it needs reserves, and what level of reserves is appropriate for their needs. This requires a certain level of financial literacy and an assessment of, for example, current and future needs, potential sources of funding and changes in the external environment.

This suggests a need for an informed debate amongst CSOs, donors, funders and the public about the cost of doing business and the need for reserves to build organisational resilience. Unless there is a willingness to invest in management and support services,

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<sup>3</sup> SQW Ltd. *Research on Third Sector Access to Finance*. London: Office of the Third Sector, 2007.

<sup>4</sup> Charity Commission, 2003, RS3 *Charity reserves*

information technology, or research and development, for example, CSOs will always have to struggle between short-term survival and long term impact. This in turn will undermine their capacity to deliver better services and programmes to beneficiaries.

However, some of the barriers that prevent organisations accessing the capital they need are internal. Too often reserves are held simply to cover contingencies, as evidenced by the ‘3-6 months running costs’ criterion, and are not seen as a potential source of development capital. Organisations that have a good understanding of their current and future financial position and the sources of funding available to them are in a much better position to plan and prioritise their funding needs, thereby becoming more sustainable and resilient in the longer term. But many organisations do not have the financial literacy needed to differentiate between capital and revenue funding, or understand why both are needed. Poor financial and business planning and an aversion to risk can also translate into a reluctance to seek investment in the long term health and effectiveness of the organisation<sup>5</sup>.

## **2. Access to capital**

The availability of capital can make an organisation more resilient and give it the capacity to deliver its mission more effectively. CSOs use financial capital to build capacity in one of four ways:

- as *reserves* or *insurance* to give resilience, protecting the organisation and its activities against the unexpected happening;
- to acquire the *fixed assets* necessary to deliver on-going services, projects and activities;
- as *working capital* to manage timing differences between spending money and receiving it (cash flow) thereby enabling on-going activity;
- as *development capital* to fund the costs of:
  - growing existing services and projects
  - developing the infrastructure of the organisation e.g. through IT, or financial systems, or marketing
  - innovation in new products, processes and services;

### *Supply and demand*

Different types of capital carry different levels of risk. Capital that is used to support the acquisition of fixed assets, such as premises, can be secured against those assets and is therefore relatively low-risk for both the investor and recipient. There is strong evidence of demand from CSOs for this type of finance. For example, the majority (81%, £22m in 2008) of Charity Bank’s loans are long-term (over five years to maturity) and are

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<sup>5</sup> An analysis of non-profit operating reserves in the Washington area by Amy S. Blackwood and Thomas H. Pollack (Urban Institute July 2009) shows that low levels of reserves are not just a UK phenomenon. Nearly three quarters of organisations relying primarily on government grants and nearly two thirds of organisations relying primarily on programme service revenue reported less than three months in reserves. Arts, culture and humanities organisations had the lowest levels of reserves.

usually secured against fixed assets<sup>6</sup>. It is more difficult to assess the extent of demand for, and supply of working capital to CSOs, although it appears to be available through both commercial and social investment institutions. This includes the provision of overdraft facilities to help organisations cope with ‘lumpy’ cash flows, e.g. where payment is made in arrears.

Most CSOs will still look to sources of free capital for acquiring or developing fixed assets. This has been provided by a range of different grant makers, including the National Lottery, trusts and foundations and public sector agencies, as well as often being the basis of major appeals to the general public.

Less certain is the demand for, and availability of, development capital. The most significant source of development capital, as with capital for fixed assets, has been, and continues to be grants. More recently, however, there has been increasing publicity and promotion of loan finance as a source of capital for this type of investment. A number of studies have identified a need for development capital within the civil society sector<sup>7</sup>. However, the higher risk associated with loan finance, particularly in the context of contracting for public service delivery or for developing social enterprise, has meant that this level of need has not always been translated into demand.

The Government has actively intervened to increase the supply of development capital, through social investment funds such as the Adventure Capital Fund (£14m), Futurebuilders (£215m), Health Social Enterprises Investment Fund (SEIF) (£90m) and Communitybuilders (£70m), combining loan and grant finance. While there is evidence of good take up of some of this funding (Futurebuilders report applications totalling £90m per month by the time the fund closed in Feb. 2010), it is apparent that many organisations are reluctant to go down this route because of the cost of servicing the loan element and the perceived risk of such funding, if projected revenue streams fail to be realised. Some organisations have also, rightly, concluded they do not have the business planning skills or capacity to manage this type of finance. Take up of Futurebuilders and SEIF has also been limited to those organisations involved in public service delivery.

Over the next few years there is going to be an urgent need for CSOs to restructure and modernise to achieve economies of scale, increase efficiencies and modernise, both to survive the challenging financial environment, and to take advantage of new opportunities both in public service delivery and in fundraising and campaigning. For example, there could be more opportunities for both private and voluntary sector providers to deliver public services, provided they can deliver economies of scale and cost effectiveness. There is also likely to be much greater emphasis on payment by results, often requiring providers to put money upfront. Investment ahead of income generation and evidence of profitability is high financial risk. Private companies have access to commercial capital markets and the expertise to manage this. CSOs that want to compete for contracts will need access to a more mature social investment market, as

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<sup>6</sup> Charity Bank Ltd 2008 *Audited Financial Statements*

<sup>7</sup> e.g. Bank of England 2003, *The Financing of Social Enterprises*; SQW Ltd. *Research on Third Sector Access to Finance*. London: Office of the Third Sector, 2007; National Audit Office 2009 *Building the capacity of the Third Sector* London: National Audit Office.

well as the right set of skills, in order to manage in this market. CSOs will also need to invest in developing their fundraising capacity as public sector funding shrinks.

### **3. The role of grant funders**

Grant-funding plays a key role in meeting the development needs of CSOs. The Baring Foundation's *Strengthening the Voluntary Sector* programme, for example, aims to help organisations develop in order to further their mission more effectively and maintain their independence. However, the availability of capital investment in CSOs by grant funders has tended to be constrained by the same factors that inhibit the practice of all CSOs:

- a lack of understanding of the different approaches needed for capital investment and revenue funding;
- a reluctance to contribute to reserves or to fund organisations with reserves above a certain level;
- limited organisational capability to manage social investments; and
- a conservative approach to risk that might include, for example, a reluctance to invest in developments that do not have easily-identifiable outcomes.

#### *Intelligent funding*

A number of grant-making bodies have recognised that they need to change this financial model and fund more 'intelligently'. The intelligent funding model focuses on outcomes, rather than activities, and provides support to organisations to help them deliver and sustain the work throughout, and beyond the life of the grant. Although this may cost more to administer, it is more cost-effective in the long term if it means that grants are used more efficiently and effectively and thereby achieve greater impact. It is a model that could be used by other funders, including government.

#### *Investment*

Grant making foundations hold 31% of the sector's assets.<sup>8</sup> This tends to be invested through commercial vehicles to attract a market-rate financial return. This approach to investment allows trusts and foundations to protect permanent endowments, and support CSOs through distribution of grants. However, it also means that most of this capital is not available for use within the sector. Investing more of the capital held by trusts and foundations in the sector would see greater supply (and therefore better access to capital), which could strengthen the financial resilience of CSOs and facilitate more voluntary activity.

Some grant-making institutions have started to use their financial capital to support their mission<sup>9</sup>, either through:

- *Mission-Connected Investment*, investments made in line with charitable mission, but with expectation of near commercial returns; and
- *Programme-Related Investment*, investment that seeks a social as well as (or instead of) a financial return on capital.

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<sup>8</sup> If medical research organisations, which primarily achieve their mission by making grants to fund research, are included grant-making charities hold 50% of the sector's assets. (NCVO Almanac 2010. The Almanac's definition of charities excludes housing associations, faith groups, trade associations, independent schools and those charities that are not independent of government, such as NHS charities).

<sup>9</sup> e.g. N Sargon and M Bolton, 2008, *Mission Possible: Emerging opportunities for mission-connected investment*, London: New Economics Foundation; M Bolton, 2005, *Foundations and social investment*, London: Esmee Fairbairn Foundation.

Both these approaches, sometimes collectively described as *Impact Investing*, allow trusts and foundations to invest some of their endowments in ways that enable more of the money held by trusts and foundations for the sector to be actively used within the sector.

At the same time some trusts, such as the Esmée Fairbairn Foundation, have begun to use a broader range of financial instruments to increase the supply of capital to CSOs, for example by offering loans where other lenders are not prepared to take the risk, alongside their traditional grant-making activities. This means limited resources can be used as efficiently as possible, enabling capital to be recycled where possible, whilst ensuring that grants are still available for those who need them.

#### **4. Developing a social investment market**

A discernible, if immature, social investment market has developed in the UK over the last decade, with an ever-widening range of investors, funds, advisors and, importantly, CSOs participating. Some of the main players in this market are:

- Social investment banks, such as Charity Bank, Triodos and Unity Trust Bank
- Community Development Finance Institutions (CDFIs) and their trade body, the Community Development Finance Association (CDFA)
- Venture capital funds targeting disadvantaged areas, such as Bridges Community Ventures
- The range of government funds referred to in Section 3 above and the Social Investment Business, which manages them
- Niche providers of capital and support, such as CAF Venturesome and venture philanthropy funds, such as Impetus Trust
- Trusts and foundations, such as Esmée Fairbairn Foundation

This market has at least three functions:

- to build the capacity of the sector to achieve impact;
- to use financial capital efficiently within the sector; and
- to increase access to capital for the sector.

The infrastructure for the social investment market is also developing. This includes specialist funds to support particular activities (social enterprise), or sub-sectors (youth organisations), as well as a number of advice and information services to support organisations seeking capital and those wanting to invest in the sector.

However, the market for social investment is still poorly developed. A more mature market would give CSOs access to a wider range of funding and financial options than at present. A Social Investment Wholesale Bank (SIWB), funded by unclaimed assets, was proposed in the Dormant Bank and Building Society Accounts Act (2009) to help facilitate the development of such a market. To be effective the SIWB will need to be fully independent of government and should have an explicit wholesale function; if it were to compete with existing retailers it would distort, rather than develop the market. It must also be sufficiently well capitalised and will need at least £250m of capital from the outset. This would enable it to operate independently and with minimal risk to its initial capital.

The Government has now announced its plans to establish the Big Society Bank (BSB) using all the proceeds from unclaimed assets. They plan this to open by April 2011 and estimate that it will initially have £60m available for loans. The British Bankers Association estimate this could increase to £400m over time. The aim of the BSB is to help develop the social investment market. The BSB is able to take risks which commercial investors cannot and is therefore well placed to leverage in private investment and can operate in the space which covers both concessionary and near commercial finance.

*Individual investors*

A question for the future is whether, and to what extent, private individuals or institutions will be willing to invest money for a social as well as a financial return. A small but growing number of wealthy philanthropists have actively supported efforts to supply investment capital to CSOs<sup>10</sup>. Examples include the use of venture philanthropy through organisations such as the Impetus Trust and the Private Equity Foundation, as well as social lending and social venture capital approaches through organisations such as Venturesome or Bridges Ventures Social Entrepreneurs Fund. These approaches and vehicles are designed to promote investment in organisations, not just projects, so that those organisations can reach more people and have a bigger impact than would otherwise be possible.

Relatively little progress has been made in getting more donors to support or invest in capital funding, particularly to smaller organisations, although there have been some interesting new initiatives, such as Scope’s Venture Philanthropy package (see box below).

**Scope’s Grangewood Venture Philanthropy Package**

Scope has £20m of property which is currently home to around 600 disabled adults. Most of these services are in desperate need of modernisation. Grangewood in Essex is one such service, which Scope plans to modernise by building 15 new flats where disabled people will be able to live independently.

The total cost of the project is £2.7m (£18,000 per unit), but Scope already owns the land, so needs to raise £1.8m to finance the project. The revenue for supporting each service user is funded by the local authority and Scope’s business model means they can run the service at a surplus, which could support a £750,000 mortgage at a semi-commercial rate from lenders such as Charity Bank, Triodos and Unity Trust Bank. However, they will not lend until the remaining £1.05m is in place.

Scope’s plan is to raise the deposit by selling ‘packaged units’ to individual investors, consisting of:

- £1750 Net donation (needs to be £2800 gross)
- £1750 Gift aid and tax relief
- £7000 Three year interest free loan (repaid from sale of existing building)

<sup>10</sup> Goodall and Kingston, 2009, *Access to Capital* London: Venturesome

£10,500

£7500 Commercial loan to 'match fund' each investor unit

£18,000 Total for each unit

This means that every donor who gives £1750 net of gift aid and lends Scope £7000 interest free for three years generates £18,000 investment in the project i.e. leveraging by a factor of 10. Each unit holder will be issued with legal documentation and a 'loan note'.

Scope has a number of actual and potential high net worth supporters who they are now approaching with this proposition. If successful, they plan to use this model to finance around £40m redevelopment of other services.

There have also been a small number of on-line initiatives, such as Kiva, which may also have wider potential. Kiva is a web-based intermediary that encourages and enables people to invest in projects to alleviate poverty through the provision of micro-finance. Unlike a charitable donation, the investment is in the form of a loan which is paid back. It was first established in the United States, where it raised \$100 million and attracted more than 500,000 lenders in its first four years. It has been operating in the UK since 2008.

This suggests that there is interest in micro-finance approaches, but it is at a relatively low level and applied to projects in developing countries, rather than in the UK. It remains to be seen whether the same principles can be applied in this country to fund civil society activity, particularly small scale projects.

#### *Commercial investment*

There is an important distinction to be made<sup>11</sup> when discussing the aims of social investment (apart from grant funding), between:

- Finance-first investment, where the prime aim is to achieve a financial return, but the investor may also be interested in achieving social impact. (= 'finance led capital').
- 'Impact-first' investment, which is defined as 'actively placing capital in businesses and funds that generate social and/or environmental good and a range of returns to the investor' e.g. from simply getting your money back to an above market return i.e. these investors are prepared to give up some financial return if they have to (= 'impact led capital').

Provision of finance led capital to the sector has increased significantly in recent years as the commercial banks and the social banks have both done more business with the sector, particularly around property purchases. NCVO estimate that charities currently have loans worth £2.89bn, most of which are for property purchases. However, provision of impact led capital is much harder to attract into the sector, but is very important in meeting the need of many organisations to secure more development and working capital and to become more resilient.

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<sup>11</sup> Parthenon Group/Bridges Ventures 'Investing for Impact-case studies across asset classes' 2010.

Few organisations are able to repay unsecured loans at commercial prices. Nor should they be encouraged to take out loans on this basis. Banks themselves are interested in maximising financial returns first and are likely to be uninterested in sacrificing even part of that in favour of social impact. Therefore commercial investment is only appropriate under certain conditions where the interests of investor and investee coincide, i.e. where there is opportunity to maximise social and financial returns. For example where:

- development costs can be secured against fixed assets (as in the case of a housing association or care home); and
- there are predictable income streams sufficient to cover the cost of servicing a loan.

In this connection, it is significant that Triodos Bank has closed its £3m social investment fund, which had been set up to make equity investments in growing social enterprises, because there were not enough businesses that met their criteria. It is also significant that a charity wanting to invest £20m of reserves in social enterprises was unable to find financial institutions willing to manage a portfolio of this size; the maximum they were willing to take on was £2-3m.<sup>12</sup>

In its recent report,<sup>13</sup> CAF Venturesome concluded: ‘The majority of existing vehicles for social change are simply not able to deliver commercial returns. Their activities and business model cannot afford it. This does not mean that these organisations are ineffective or inefficient, or that they should be denied access to appropriate and affordable capital so that they may become more resilient. It does, however, have implications for the financial expectations attached to investors’ capital, and the type of capital that the sector can afford.’

However, there may be other ways in which financial institutions can support social investment– for example by acting as a broker for individuals who are willing to invest for social impact or by using their financial expertise to enable CSOs to achieve their goals.

### *Social Impact Bonds*

There is currently growing interest in developing alternative models of social finance. These include taking commercial financial models and adapting them so that they align social and financial returns. For example, Social Impact Bonds, designed to fund longer-term interventions that address the root causes of social problems, rather than their consequences, e.g. to prevent reoffending by ex-prisoners.

These work by raising private investment on the strength of a government contract, where the government agrees to pay a proportion of any savings made as a result of the intervention (e.g. reducing the rate of offending and readmission to prison) to the investors. This has a number of advantages, including:

- giving CSOs a stable revenue stream that focuses on outcomes, rather than outputs, with financial risks borne by the investor;

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<sup>12</sup> ‘Philanthropy in the 21<sup>st</sup> century: a discussion paper for the Honorary Treasurers’ Forum’ prepared by Lindsay Driscoll and Peter Grant, published by Cass Business School, City University, 2010

<sup>13</sup> ‘Building a Resilient Civil Society: the Role of Social Investment- reflections of an impact-first investor’, CAF Venturesome Working Paper, July 2010

- enabling government to continue to fund acute provision in parallel with preventative measures; and
- bringing private investment into the civil society sector.

The Social Impact Bond is currently being piloted by Social Finance with ex-offenders from Peterborough prison. Metrics for measuring performance have been agreed with the Ministry of Justice and initial investment has been secured from trusts and foundations and other agencies. If the pilot is a success, the bond has the potential to attract commercial investment. (see the Commission's paper on Public Sector Funding for further discussion of this approach).

#### *Civil Society Organisations*

Larger CSOs also have the potential to invest in developing the capacity of smaller CSOs operating in the same field. This would enable them to maximise social impact for their beneficiaries, as well as potentially achieving economies of scale through collaborative working. A pilot to test out this approach is being run by New Philanthropy Capital in association with Joe Ludlow.

#### *Health warning*

The new approaches to capitalising the sector discussed in this paper will not be relevant to all types of CSOs and will continue to represent a small, but growing element of the funding of the sector. However, the need for capital is something which most types of CSOs share, apart from micro organisations operating on a completely voluntary basis. Grants will continue to be the main source of capital for most CSOs, but the challenge for the sector is to try and choose the most appropriate source of finance for particular needs– and to only use grants, when only grants will do.

### **5. Aims**

One way of measuring a better capitalised sector is through the levels of free reserves. In 2007/08 charities' reserves stood at £16bn after discounting the amounts held by grant making, research, housing and religious bodies<sup>14</sup>. The Commission's aspiration is to see this double by 2020. This could be achieved if charities maintained, and invested, their 2007/08 surplus of income over expenditure (£1.7bn) for each of the next 10 years. This would then mean their average levels of reserves would increase from six to 12 months operating costs.

Increasing levels of free reserves is, in simple terms, achieved by either generating more, or spending less, income. Apart from fundraising, for many CSOs, this means either generating surpluses on, properly priced, contracts or projects; or raising new capital for investment in buildings and organisational development, rather than spending income for these purposes.

The first approach requires changes in behaviour by commissioners and grant makers, as well as by CSOs when negotiating contracts or applying for grants. The second approach requires a supply of different sources of investment capital, as well as an ability and willingness by CSOs to embrace new forms of finance.

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<sup>14</sup> NCVO Almanac 2010.

The Commission's aims are both to make better use of existing funds to help capitalise the sector and to increase the amount of both 'impact led' capital and 'finance led' capital coming into the sector.

**The Commission's aspiration is to help charities double their level of free reserves by 2020 from £16bn to £32bn, thereby increasing the sector's size, scope, capacity, independence and resilience.<sup>15</sup>**

## **6. Making better use of existing funding to capitalise the sector**

This involves:

- increasing public understanding about the need for CSOs to develop their capacity through investing in:
  - governance and management
  - support services and IT systems
  - staff training and research and development.
  
- increasing the financial literacy of the sector and thereby helping it to:
  - recognise the need to acquire capital
  - understand that capital is not just fixed assets
  - be more willing to apply to funders for capital
  - analyse the full costs of service delivery, including the cost of capital and the need to generate surpluses
  - get better at risk management and become less risk averse
  - develop effective business plans which provide investors with the confidence to invest
  - make the best use of different types of funding e.g. only using grants where only grants will do, using debt, quasi equity or other financial instruments, where appropriate
  - recognise the importance of only using commercial capital where social objectives are aligned with commercial ones i.e. avoid mission drift in the pursuit of financial return.

### **Case study– Expanding the Financial Toolbox**

Mission Models Money's (MMM) vision is to transform the way the arts use their resources to support the creation and experience of great art. One of their work streams has sought to help creative practitioners and organisations become more financially resilient by encouraging:

- recognition of the concept of undercapitalisation and the importance of

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<sup>15</sup> This aspiration excludes research, grant making, housing and religious organisations, whose levels of reserves are significantly higher than all other types of charities. In order to achieve this aspiration, these other voluntary organisations would need to maintain, and retain, their 2007/08 surplus of income over expenditure (£1.7bn) for each of the next 10 years.

addressing it

- recognition of the range of financial mechanisms other than grants that can achieve capitalisation e.g. provision of/use of loans and revenue (risk) sharing arrangements
- investment in building organisational capacity to support delivery of programmes and associated services
- encouraging new forms of revenue generation specifically through activities that contribute directly to mission (rather than subsidiary trading)
- seeking recognition among funders of the importance of providing grants to support research and development activity and assist the transition to new ways of working aimed at achieving greater resilience.

- encouraging grant makers to:
  - fund full cost recovery plus a contribution to reserves where appropriate
  - provide grants for capacity building
  - provide longer term grants
  - complement debt finance provided by other investors with grants to fund those aspects of the investment where this is no financial return e.g. capacity building
  - recognise the importance of adequate levels of reserves, rather than seeing them as a reason not to give
- encouraging public sector commissioners to:
  - specify outcomes, rather than inputs and outputs
  - continue to use grants where appropriate
  - when procuring through competitive tendering, to pay by competitive price not by analysing costs
  - allow providers to retain surpluses
  - invest in market development
  - make full use of opportunities to transfer capital assets
- encouraging major charities to:
  - build the capacity of smaller charities working with the same client group, as a way of pursuing their mission more holistically
  - provide relevant business consultancy advice and investment
  - seek voluntary income, e.g. from venture philanthropy funders, to help pursue this approach.

## **RECOMMENDATION 1– Increasing financial literacy**

### **Background**

- **Most trustees and staff of CSOs have a poor understanding of the importance of capital for organisational development or the different options open to them for building up capital and financing their organisations' activities**
- **As a result, they will often be risk averse and will tend to use grant income, when a better option might have been to use debt, quasi equity or other**

**financial instruments**

- **The lack of financial literacy also applies to some of the suppliers of finance to CSOs, including the boards and staff of many charitable trusts and foundations**

**Proposal**

- **The Charity Finance Directors Group should work with NCVO, NAVCA, ACEVO, Skills- Third Sector and the commercial sector ( including the financial services industry), to build on and develop the financial literacy programmes currently available for sector chairs, treasurers, chief executives and directors of finance (or their equivalents in smaller organisations).**

**Benefits: all civil society organisations with resources (apart from micro organisations (< £10k) reliant on low levels of individual donations).**

**RECOMMENDATION 2 – Using existing funding to help capitalise the sector**

**Background**

- **Most CSOs are under capitalised; income and expenditure are very closely matched, leaving them vulnerable to changes in public policy or financial down turns, and their reserves for development or working capital are much lower than the commercial sector, making it difficult for them to compete or to withstand late payment regimes**
- **Trusts and Foundations are an important source of donated capital for many CSOs and, by funding the full costs of projects, providing core grants for capacity building and funding on a longer term basis, can help capitalise the sector, particularly where the provision of debt finance in isolation is not viable**
- **Trusts and Foundations are in a position to complement debt finance, funding those aspects of the investment where there is no financial return; some are also in a position to take higher risks with their own investments, than commercial investors and a few are now doing this as a way of furthering their mission.**

**Proposal**

- **ACF should secure funds to carry out a survey of current trust and foundations' grant making practice and use the results to help develop the grant making and social investment initiatives and approaches outlined above**

**Benefits: all civil society organisations with resources (apart from micro organisations (< £10k) reliant on low levels of individual donations).**

## **7. Increasing the new funds available for capitalising the sector**

There are essentially two ways of attracting more capital into the sector:

- Through attracting more grants or individual donations that can be used for capacity building
- Through attracting more impact led and more finance led capital, where the investor expects a financial return, even though it may only be just getting their money back.

Or through a combination of the two as in the Scope case study above.

### *Creating a market*

A market requires the following conditions:

- Financial return for investors is achieved through CSOs:
  - Negotiating properly priced contracts with the public sector which reflect the cost of capital
  - direct trading with the public for goods or for services, such as long term care
  - making surpluses through repayment of microloans for enterprises run by individual entrepreneurs in developing countries
  - making efficiencies through collaboration, shared support services or merger with other organisations
  - purchasing property instead of renting
  - selling existing assets
  - raising voluntary income (e.g. from a building appeal)
- Risks for investors are managed (but not necessarily eliminated) by:
  - thorough due diligence of investment proposals
  - charges on property or on reserves
  - partnership funding with trusts and foundations, who can provide the grant element required to make the investment viable or to provide initial capacity
  - partnership funding with the public sector
  - government guarantees (where government has the explicit aim of leveraging private capital in order to supplement reduced government investment)
  - providing relevant advice on investment instruments being used
  - investors ultimately being willing to see a semi-commercial return.
- incentives for investors are provided through:
  - social recognition of individual philanthropists
  - tax incentives for providing capital (e.g. gift aid, inflation proofing and tax exemptions)
  - provision of financial return for investors as well as social return
  - provision of more capital to community development finance initiatives (CDFIs) through the BSB to help them capitalise smaller CSOs
  - social impact bonds, providing investors with a share of savings to the public purse resulting from preventative services (see Funding Commission's paper on Public Sector Funding for recommendations on Social Impact Bonds)

- using the BSB to encourage trusts and foundations to provide part of their endowments for investing in the sector by providing matched capital funding
- using the BSB to attract more private investment by providing capital to lenders on a matched funding basis
- requiring high street banks to invest in the sector through a Community Reinvestment Act, adapted to the circumstances of the UK ( perhaps through specialist intermediaries, such as CDFIs)
- Developing new forms of Gilts and Bonds, which provide opportunities to attract impact led and finance led capital.

### **Case study– Social Investment Bonds**

The first social investment bond, developed by Citylife and backed by Sheffield City Council, raised £800k for job creation and housing schemes in Sheffield. Citylife lent the money raised from the bond to social housing providers that used the interest and charitable tax benefits as seed-corn funding for new jobs.

Now Citylife has issued a bond of up to £20m for east London, which aims to provide investment for more social housing provision, while other community projects will be coordinated by the Bromley on Bow Centre and Community Links. Subscriptions are about to close, but so far include £100k each from the City Bridge Trust, Apax Foundation and two commercial companies. Citylife’s chief executive says the total is still well below its target, perhaps because east London doesn’t have the same sense of community as Sheffield.

Based on article (‘Bond of hope’) by Martin Wainwright, Society Guardian, 14 July 2010

- investors’ reluctance is overcome through:
  - development of a clearer menu of investment opportunities offering a range of different financial returns and social impacts
  - ensuring financial advisers are more aware of the potential for achieving financial and social return
  - equating social investment with ethical investment
  - emphasising that higher levels of social impact can be achieved this way than through a purely grants based approach
  - encouraging banks to develop new forms of financial instruments appropriate to the sector, pro bono, as part of their CSR activities.

- CSOs' reluctance is overcome through:
  - provision of business consultancy support to develop investment readiness (see Funding Commission's paper on Effectiveness)
  - developing the advice available to trustees and CEOs to encourage them to be less risk averse (see Recommendation 1)
  - inclusion of a grant element in investments where this is necessary for capacity building or for ensuring viability in adverse markets
  - development of new accounting protocols for distinguishing between earned and voluntary income and for the treatment of reserves and assets on balance sheets so that their purposes are more clearly and transparently identified.

### **RECOMMENDATION 3 – Attracting new private capital into the sector**

#### **Background**

- **A discernible, if immature, social investment market has developed in the UK over the last 10 years, with the help of government financial investment**
- **A small, but growing number of wealthy philanthropists have actively supported efforts to supply investment capital to CSOs**
- **Provision of so-called 'impact led capital' where the investor is seeking to generate social and environmental good alongside a range of financial returns ranging from simply getting their money back to an above market return, is much harder to attract to the sector**

#### **Proposal**

- **Treasury to establish a Task Force to assess the feasibility of, and recommend instruments for, attracting new private capital into investment (initially) in health and social care services provided by voluntary organisations or social enterprises.**
- **The Task Force should:**
  - **Comprise senior civil servants from the Treasury and relevant spending departments, investment bankers and representatives of the organisations in the health and social care sub sectors**
  - **Consider the potential for :**
    - **a Social Gilt to attract investors concerned with social impact**
    - **Local Health and Social Care Bonds (e.g. for cities like Birmingham or Manchester) to attract investors who would benefit from, or are committed to, the improvement of local services**
    - **Replication of Scope's Venture Philanthropy Package**
  - **Consider the potential for underwriting these financial instruments through:**
    - **Funding from the Big Society Bank (BSB) or funding leveraged by the BSB**
    - **Earmarking a proportion of the resale of national bank shares into the BSB for use in this way**
  - **Recommend appropriate mechanisms for investing the capital raised in CSOs wanting to deliver more health or social care**

**services, focussing in particular on long term health and social care, management of chronic health conditions and provision of personalised services, where demand is increasing and government is considering how best to respond**

- **Review the success of these investment instruments and advise on further investment mechanisms for other parts of the civil society sector.**

**Benefits: initially only those larger CSOs in the health and social care sub sectors wanting to provide services and needing to develop capacity to respond to these developing markets. Later, if successful, the target audience could be broadened.**

**Funding Commission  
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