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OPINION

4 | January 2009

The Funder's Obligation

Hard Times Can Foster Bad Decisions

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Canadian organizations which fund charities are looking with alarm at the decline of their capacity in the global economic crisis. Endowments have shrunk suddenly as the stock markets have collapsed, affecting private foundations, community foundations, universities and hospitals. Funders who rely on annual fundraising like the United Ways are watching donor behaviour with trepidation, anticipating big shortfalls to their targets. Already a number of funders have made dramatic announcements along the lines of the Ottawa Community Foundations decision to make no grants next year. Many others are "pausing" for consideration.

In a previous downturn, after the tech bubble burst at the start of this decade, there were similar concerns, although the economy was not as bad as now. One of the outcomes was some pressure on the federal government to lower the payout rate for funders from 4.5% to 3.5% of the value of assets, which they did. This meant less money flowing to charities.

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The biggest fear expressed in such tough economic times is that funders will have to "dip into capital". The idea of reducing the capital value of an endowment, for whatever reason, is considered to be the fiduciary version of original sin. The argument goes that increasing capital by putting earnings in excess of the required payout rate back into capital enables the funder to deal with inflation and continue its work into the future. So, for the most part, capital is kept in the financial markets with the reasonable, and historically supported, expectation that it will increase in value. But reducing capital means that the funder has less capacity for the future, will fall behind inflation, and therefore have to reduce its work in future years.

The regulatory requirement of the "ten year rule" says that gifts to an endowment must be held for ten years to avoid being characterized as an annual gift requiring 80% of it to be paid out in the year of the gift. But most limitations on infringing on capital are self-imposed. They are restrictions undertaken in the writing of the trust indenture of the foundation or charity, which is then submitted to CRA for approval. Those limitations do not need to be there. A relatively small percent of charitable sector assets are bound by regulation. A vastly higher percent are bound by the intent of the charity.

This is very much a donor-focused view. It gives first priority to the donor's analysis of the work to be done, and the donor's idea of appropriate timeframes. Most endowments are created with "perpetuity" as the operative timeframe, and stewardship of capital as the main job. In good times, when investments produce returns in excess of the payout requirement, these are easy assumptions. But when the economy sours and the financial markets weaken, hard choices arise. In tough times, the preservation of capital is more important than the preservation of community for some funders.

The other way to focus on these issues is from the community perspective. And the main reason to do so is because of the public policy objectives that underlie the existence of tax-protected capital pools. As a matter of policy, governments in Canada allow profits from commercial enterprise to be put into charitable funds on a pre-tax basis, on the provision that those funds be directed to charitable purposes. Again as a matter of public policy, the government (through the Canada Revenue Agency) certifies what activities qualify as charitable by the granting of charitable status to various organizations through a process of application, review, and approval.

There is considerable argument about the appropriateness of CRA definitions of charitable activity, but the focus is basically on benefits to the community. The policy promotes the application of private funds to public purposes. And much of CRA's scrutiny of charities and their funders is to guard against self-dealing or the use of funds for private interests.

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I think it is clear. It must focus on the needs of the community, and keep up its level of support for funding programs ***even if it means dipping into capital***. A responsible government is prepared to run a deficit in hard times to maintain stability and alleviate human suffering. In good times, the deficit will be eliminated and surpluses will restore budgetary balance. Similarly, funders can reduce their capital now, even dramatically if the community need is dramatic, and rebuild it later. It would also be good to consider the analysis of Michael Porter who looked at the dynamics of endowment financing at the US payout rate of 5% (almost 50% more than Canada's), and concluded that it was inefficient, and destroyed value in capital. Much better, he concluded, to spend out capital in the short term when the impact could be bigger by putting more dollars against the big problems in society.

It is better to have a strong impact when the need is the greatest, rather than just being incremental revenue for charities when times are flush. Stewards of endowments have to realize that perpetuity isn't all it's cracked up to be. The preservation of communities is more vital than the preservation of capital.