

Impact in the Balance: Leveraging Foundation Assets for Mission

An Examination Of Innovative Tools For Impact

Summary

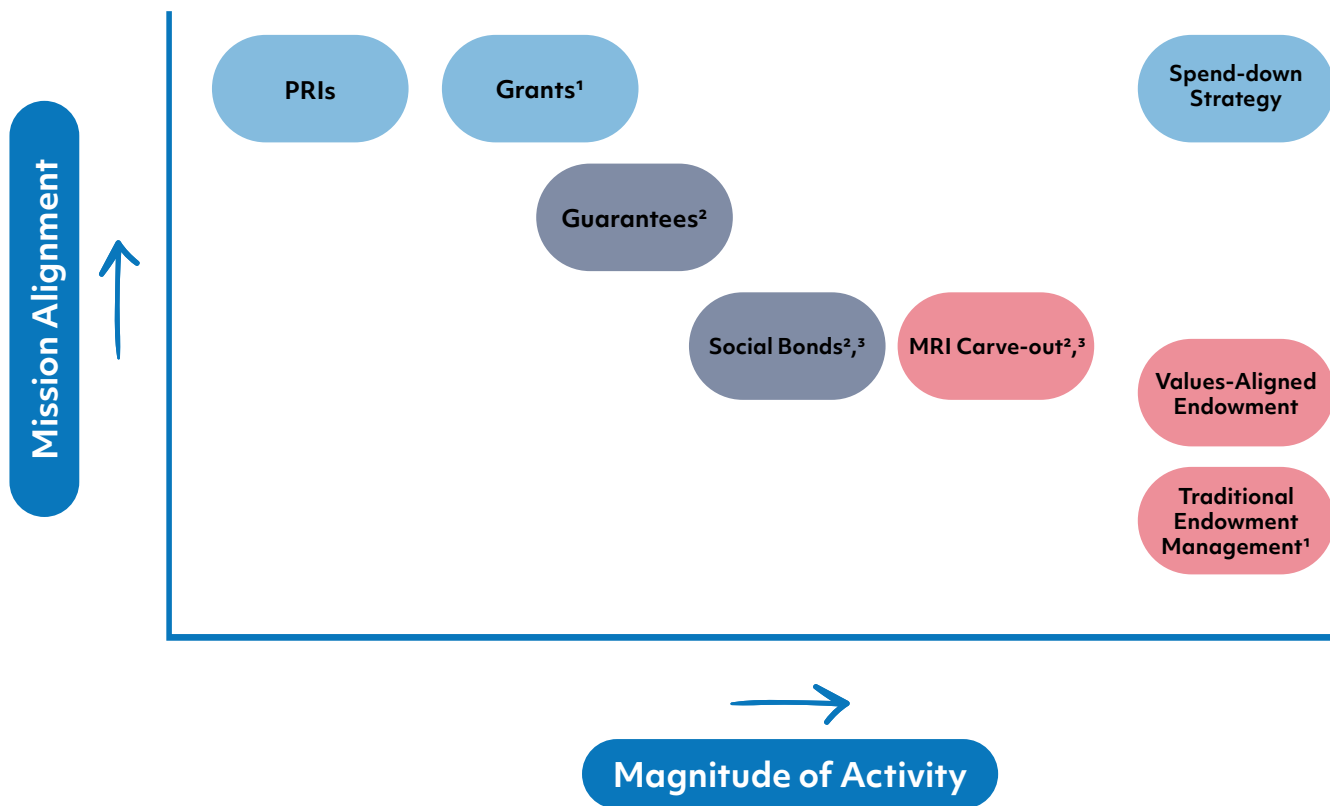
In recent decades, foundations have adopted a broad range of tools for advancing impact alongside traditional grantmaking. In light of the events – including the COVID-19 pandemic and growing attention around systemic injustices – there is a growing sentiment that major institutions need to do more with more to support the public good. Given that, the U.S. Impact Investing Alliance set out to examine how private foundations are leveraging their balance sheets for impact in innovative ways. Support for this report was provided by a grant from the Robert Wood Johnson Foundation (RWJF). The views expressed here do not necessarily reflect the views of RWJF.

To facilitate broader understanding of these tools, we are proposing a new categorization of these models based on where they sit on a foundation's balance sheet or financials.

- **Spending strategies** are reflected on a foundation's income statement and include charitable activity as part of the foundation's 5% payout rule. These tools include traditional grantmaking and program related investments (PRIs), where relevant. Learn more about the role of public policy in promoting the uptake of PRI strategies in the appendix.
- **Asset strategies** seek to align some or all of the endowment with mission. The most common asset strategies are mission related investments (MRIs) and values-aligned endowments. See the appendix for more information about the Treasury guidance that has catalyzed new MRI strategies by foundation boards and investment committees in recent years.
- **Liability strategies** are financial instruments that are booked as liabilities on a foundation's balance sheet. As it relates to mission-aligned activity, the tools that fall under this category are guarantees and social bonds. As spending and asset strategies are widely documented, these materials primarily focus on the potential for foundations to implement and expand catalytic leverage strategies.

Foundation Strategies

An Illustrative Mapping of Mission Alignment and Magnitude



Legend:



1. Traditional foundation activities associated with the incumbent model.
2. Level of exposure can vary as a percentage of the endowment, determined by senior leadership and the board.
3. Social bonds are mapped based on the financial instrument itself, versus the use of proceeds. We have thus categorized its mission alignment generally on par with MRIs based on its unique application of an otherwise standard capital markets tool.
4. Also includes operating expenses, which may include social bond interest costs (if relevant).

Comparing Foundation Strategies

These tools can differ with respect to their relative scale and level of mission alignment. The matrix on the prior page seeks to map these tools based on two dimensions: magnitude of activity (x-axis) and mission alignment (y-axis). The representation shown above is just one interpretation as the scale of these programs can vary greatly between foundations, and others may interpret mission alignment differently.

For example, MRI commitments can range from nominal to quite large, as can social bond issuances or guarantee programs. The relative scale of each tool is also not directly comparable, as grants and PRIs are administered annually whereas many of the other tools (social bonds, guarantees, MRIs) represent total exposure versus annual activity.

Another nuance is that one can interpret mission alignment based on the instrument itself versus the use of proceeds. For example, a social bond is essentially a traditional bond issuance used regularly in the capital markets, with a unique framework and use of proceeds that can be quite mission-aligned. Note: We have chosen to map social bonds based on the instrument itself versus the use of proceeds.

We expect the matrix will provoke discussion and debate, not necessarily agreement. That said, one conclusion we can draw is that the traditional foundation model – relying on grants and PRIs as the sole tools to further mission – is just scratching the surface. Foundations can and should do more to utilize more of their balance sheets effectively, even if these tools have varying degrees of mission alignment.



Spotlight: Guarantees

Guarantees are contingent liabilities offered by foundations as a credit enhancement to crowd in more or lower cost private capital for impact. Select foundations have increasingly relied on guarantee strategies after seeing the value of government guarantees in crowding in capital (e.g., SBA lending, etc.) Active guarantee providers among foundations include the Kresge Foundation, the MacArthur Foundation and RWJF.

There are several benefits to structuring a guarantee program. The first is the ability to offer unfunded guarantees, which require no cash to change hands until and unless there is a guarantee payout in the future. This structure is particularly advantageous during times when the need for liquidity is high or the desire to realize certain investment holdings is low (such as in early 2020 when COVID-19 upended the U.S. economy). Another key benefit is that, because the guarantee is booked as a liability, it does not immediately impact either the foundation's spending strategies (e.g., grants or PRIs) or the endowment. However, despite their merits, foundations infrequently utilize guarantees. A key drawback is the relative complexity of underwriting and managing guarantees relative to grants or other investments, particularly when it comes to forecasting guarantee payouts into the future.

A more recent innovation is the decision by some to couple an investment grade credit rating with a guarantee product. RWJF, for example, secured AAA/Aaa credit ratings from S&P and Moody's in 2021 to be able to provide investment grade guarantees. One advantage of augmenting the guarantee with a third party credit rating is that it can de-risk the investment and drive down pricing, providing multiple benefits to both the investors and the intermediaries receiving that capital.

Spotlight: Social Bond Issuances

The year 2020 saw a handful of foundations begin to explore a relatively new balance sheet tool – social bond issuances – to ramp up their programmatic activity in response to the triple pandemics of COVID-19, economic crisis and growing racial unrest across the United States. The core tool itself – a bond – is not new as many institutions (e.g., corporates, municipalities, university endowments) have leveraged existing capital markets infrastructure to raise capital based on the strength of their credit rating. However, utilization of this specific tool by foundations is quite new, particularly for grantmaking activity. The Ford Foundation was an early adopter of the tool, with a \$273 million bond issuance in 2017 to finance the renovation of their headquarters in New York City. Since 2020, at least eight foundations have issued social bonds, including the MacArthur Foundation, the W.K. Kellogg Foundation, the Andrew W. Mellon Foundation and the Doris Duke Charitable Foundation.

Snapshot: Foundation Social Bond Issuances

| | Closing Date | Par Amount | Endowment Size ¹ | Rating (M/S/F) ² | Term | Interest Rate | Use of Proceeds |
|---|--------------|------------|-----------------------------|-----------------------------|--|--|--|
| Ford Foundation | Jun 2020 | \$1b | \$17.81b | Aaa/AAA/-- | 30 years (\$300m) 50 years (\$700m) | 2.415% (30 years) 2.815% (50 years) | Expand grantmaking to \$1 billion in 2 years |
| Andrew W. Mellon Foundation | Jul 2020 | \$300m | \$8.22b | Aaa/AAA/-- | 7 years | 0.947% | Fund grantmaking consistent with Mellon's program areas of focus and finance previous borrowing used to pay grants in 2020 |
| Doris Duke Charitable Foundation | Jul 2020 | \$100m | \$2.54b | Aaa/--/-- | 30 years | 2.345% | Stabilize and sustain the nonprofit sector |
| MacArthur Foundation | Aug 2020 | \$125m | \$8.22b | Aaa/--/-- | 10 years | 1.299% | Voting and democracy, COVID-19 and racial and ethnic justice grants |
| W.K. Kellogg Foundation Trust | Oct 2020 | \$300m | \$8.35b | Aaa/AAA/-- | 30 years | 2.443% | Fund grants in alignment with UN SDGs |
| The Rockefeller Foundation | Oct 2020 | \$700m | \$7.12b | Aaa/AAA/-- | 30 years | 2.492% | Contribute \$1 billion over 3 years to catalyze a more inclusive, green recovery from the pandemic |
| Bush Foundation | Nov 2020 | \$100m | \$1.62b | Aaa/--/-- | 30 years | 2.754% | Allocating money directly to Black and Native American individuals |
| California Endowment | Jan 2021 | \$300m | \$4.65b | Aaa/AAA/-- | 30 years | 2.49% | Infrastructure and institutional support for nonprofits |

Disclaimer:

The information in the above table is based on publicly available information, and may not be an exhaustive list of all social bonds issued.

1. Based on most recent publicly available information for fiscal year end; all figures reported are for FYE2020 with the exception of Kellogg and California Endowment (both FYE2021); endowment size will fluctuate year to year based on investment performance and other factors.
2. Moody's/Standard & Poor/Fitch, -- denotes that there is no rating by that particular credit rating agency.

A host of factors contributed to the decisions by these foundations to issue – or not to issue – social bonds at this time:

Urgency of this moment in time:

The set of crises – COVID-19 pandemic, economic downturn, racial injustice – in the United States prompted many foundations to act quickly to aid in the response. Many organizations felt that these crises commanded a higher than normal level of giving and necessitated a new and creative tool. That said, not everyone ascribed to this point of view. The Kresge Foundation, for example, elected not to issue a social bond as they did not believe they could determine whether the need in 2020 was more acute than it was in the past or would be in the future. Of foundations that did issue a bond, their perspectives on this topic also varied. The Ford Foundation specifically issued longer term bonds (30 and 50 years) and deemed this bond issuance to be a “once in a lifetime” event, suggesting this as a tool to be used once and not replicated. The MacArthur Foundation issued only 10-year bonds and fully expects to repay those bonds when due, suggesting the potential for utilizing this strategy again going forward. Therefore, while most if not all would agree that 2020 was a time of great need, there were differing opinions on how relative the need was and the right tools to deploy.

Stock market performance:

While they seem separate, the performance of the endowment and annual giving are inextricably linked. Oftentimes, during the most troubling times, endowments lose value as stock markets plummet, which reduces payouts at a time when they are the most in need. This certainly was the case and expectation in early 2020 (though the market quickly rebounded). As many foundation executives anticipated a tightening of their grant budgets in early 2020, they sought out other models to ramp up giving while leaving their endowments untouched.

Strength of credit rating:

A key precondition to tapping into the capital markets is a strong credit rating, which allows the issuer to attract low-cost debt. Organizations such as the Ford Foundation, Rockefeller Foundation and W.K. Kellogg Foundation all received AAA/Aaa ratings from rating agencies such as S&P and Moody’s. The strength of their balance sheets, low levels of leverage and social bond designation also led these bond issuances to be oversubscribed by both impact and traditional investors. Thus far, foundations ranging from \$1.6 billion to \$17.8 billion have been able to issue investment grade bonds.

The combination of a low interest rate environment and a volatile stock market resulted in a “flight to quality” by investors particularly to the bond market. This resulted in near optimal conditions for issuing a bond in mid-2020 by these organizations.

Another unique feature of these social bond issuances was the decision by several foundations to engage minority-led underwriting firms in addition to more traditional actors. Common underwriters included Morgan Stanley and Wells Fargo, and some foundations, including the MacArthur Foundation and the California Endowment, also engaged minority-led firms like Loop Capital and Siebert Williams Shank.

This is a great example of extending the impact of these social bond issuances from just the tool or use of proceeds to the process as well.

What Comes Next?

The purpose of these materials is to encourage foundations to do more with more. This includes implementing new strategies that expand the use of the balance sheet for mission, as well as modifying existing tools to encourage risk taking, innovation, and field building. Many foundations are already implementing and scaling many of these tools, and we encourage more foundations to expand their breadth and for all foundations to utilize these tools with more regularity and at greater scale going forward.

See pages 8-9 for the appendix materials on PRI and MRI strategies.

Spotlight: PRI Public Policy

Program-related investments (PRIs) were first defined as part of §4944 of the Internal Revenue Code, which was adopted in 1969 to prohibit “jeopardizing investments.” In the 1960s, there was concern that foundations investing in emerging investment structures, such as private equity and venture capital, could be endangering charitable assets through risky speculation. PRIs were created as a carve out from this new prohibition. To qualify a PRI must satisfy three basic requirements:

1. That the primary purpose of the investment is to accomplish one or more of the foundation’s charitable purposes;
2. That no significant purpose of the investment is the production of income or the appreciation of property; and,
3. That the funds not be used for politicking, lobbying, or other prohibited political activity.

As an additional incentive to make these types of investment, they are counted towards a foundation’s mandated 5% payout requirement.

To illustrate how these requirements can be applied, in 1972 the IRS published nine examples of qualifying investments and one example of a non-qualifying investment. These initial examples primarily focus on situations wherein PRIs are designed to benefit “economically disadvantaged individuals” or “deteriorated urban areas.” Though these examples were not meant to be exhaustive, their narrowness contributed to overly conservative interpretations of PRI permissibility. Even as the charitable purposes described by these examples were limited, the investment tools described were quite broad. One of the 1972 examples, for instance, even contemplated a qualifying PRI made into a large, publicly traded company.

In response to calls from practitioners to further clarify PRI permissibility, the IRS issued nine new examples of qualifying investments in 2016. Among other things, these new examples confirmed a more expansive view of the tool, including:

1. That PRIs could be structured as equity investments or credit enhancements;
2. That PRIs could be made alongside commercial investors at similar terms and could potentially generate significant financial returns; and,
3. That PRIs could be made to advance charitable purposes other than serving to benefit economically disadvantaged individuals.

Though a number of foundations have successfully pursued these approaches for decades, this recent guidance should encourage others to think expansively about PRIs as a philanthropic tool.

Spotlight: MRI Public Policy

Like PRIs, the emerging practice of **mission-related investing (MRI)** is primarily regulated by §4944 of the Internal Revenue Code at the Federal level. Because MRIs take impact into account in addition to traditional financial considerations, one could think that these strategies run afoul of the prohibition on jeopardizing investments. The Treasury Department and the IRS, however, have sought to put those concerns to rest.

In guidance issued in 2015, the Treasury Department stated (emphasis added):

*When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, **including the relationship between a particular investment and the foundation's charitable purposes.***

This guidance was catalytic in encouraging boards and investment committees to approve new MRI strategies. Importantly, it recognizes that foundations can reasonably accept some level of financial trade-off when making MRIs, noting that “foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity.” Instead, as foundations assess individual investments, they are instructed to consider effects on the entire portfolio and whether it will enable the long-term charitable purpose of the institution.

This view is also consistent with long-standing state regulations. In that context, foundations and other nonprofits are generally permitted to consider an asset’s “relationship or special value” to their institutions’ charitable purposes.

Still, MRIs are not explicitly defined by federal or state regulation, which has led to many calls to codify the 2015 Treasury Department guidance as part of the Internal Revenue Code. While doing so would provide further assurance and clarity to foundations looking to develop MRI programs, existing regulations provide ample latitude for foundations to explore innovative and dynamic strategies.