UBS

F4F – Finance for Foundations

Expanding the Toolbox for Impact

Matrix Group Discussion Paper[1]

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1. CONTEXT

The UBS Philanthropy Forum 2007 introduces the concept of Matrix Groups. At the Forum, philanthropists and experts are invited to join groups that will explore themes of common interest. The groups will discuss opportunities for action in dedicated workshops and provide a point of departure for possible future joint work. For each Matrix Group, the Forum will provide a framework and background material for discussion.

This paper underpins the matrix group on **Finance for Foundations (F4F)**. The F4F Matrix Group is designed to look at the challenges and opportunities associated with investing foundation assets for optimal financial and social returns.

2. BACKGROUND

Changing investor preferences and financial innovation are rapidly altering the constraint-opportunity set for financial investment in general and foundation asset management in particular.

Many investors want to "do good" and "do well" with a part of their portfolio. At the same time, there is growing investor interest in low-volatility opportunities and/or segments of the market uncorrelated with mainstream global benchmarks (e.g. capital guarantee and absolute return products). As globalization and geopolitical events help to increasingly drive capital towards the periphery, new opportunities from previously unattended populations come on stream. As a result, emerging market funds with a sustainable development angle are becoming more relevant. They are often theme-oriented (sustainable development, environment, water, renewable energy, housing, small enterprise, etc.). Ethical funds, sustainable investments and socially responsible ventures – commonly aggregated under the umbrella term "socially responsible investments" (SRI) – have seen substantive growth: the global market for SRI funds was estimated by OWW Consulting, a CSR consultancy, to be around US$ 4 trillion in 2005.[2] More recently, a cross-country study estimated the market for broad SRI funds in Europe to be over €1 trillion, accounting for 10-15% of assets under management and a real growth of

[1] This paper was prepared by Dr. Maximilian Martin, Global Head, UBS Philanthropy Services, Visiting Professor, IOMBA Program, University of Geneva and Senior Fellow, Center for Public Leadership, University of St. Gallen. Substantive input by Andreas Ernst, and research assistance by Dweep Chanana and Lukas Stuecklin are gratefully acknowledged. This document is intended as a basis for discussion, in particular at the UBS Philanthropy Forum 2007 in the Matrix Group F4F. Opinions expressed are those of the author(s) and do not necessarily reflect those of UBS or UBS Philanthropy Services. The paper is not intended to serve as an offer, endorsement, source of primary data, or illustration of effective or ineffective management. Copyright is held by the authors of the specific sections and UBS Philanthropy Services.

[2] See http://www.oww-consulting.com/socially-responsible-investing/the-size-of-the-socially-responsible-investing-market.html

36% (absolute growth was 106%).[3] The kind of reasoning that underlies SRI can also be applied to the space of non-listed companies.

3. MAPPING OPPORTUNITIES FOR FOUNDATION ASSET MANAGEMENT

The quest for financial and social returns can be applied to the field of philanthropic action as well. Just like mainstream investors, foundations can do good and well at the same time. This approach is often referred to as "blended-value" or "mission-investing": investing (a part of) the endowment to achieve both financial *and* social returns. If charitable foundations look holistically at expenditure and investment policies as complementary ways to further their mission, they can generate greater social impact. In addition to distributing 2%-5% of assets every year to civil society organizations or social programs, a foundation can also invest some part of the other 95%-98% of assets under its control – the endowment – to further its philanthropic agenda without sacrificing the financial returns of endowment assets.

Mission-related investing may be part of the answer to greater foundation impact. But there is an additional argument to consider. Funding a foundation's programmatic work today without compromising its ability to pursue such work in the future requires that the endowment generates sufficient financial returns. For example, if a foundation's mission is to grant university scholarships and university tuitions rise on average by ten per cent a year, targeting an annual inflation adjusted return of five per cent would lead to a gradual reduction in the endowment's ability to fund the foundation's mission. To overcome this payout hurdle rate large university endowments (e.g. Harvard, Yale) have achieved high financial returns by allocating a significant percentage of their portfolio to alternative asset classes such as private equity or hedge funds. For smaller endowments, the question is often how to gain access to appropriate investment opportunities.

4. A FRAMEWORK FOR ACTION

Foundation boards seeking greater impact through financial investment need to grapple with the following two questions:[4]

- How can we invest part of the endowment into assets that create both risk-adjusted financial returns and social impact?
- How can we generate higher risk-adjusted financial returns through investments in alternative asset classes?

To facilitate the preparatory thought process, this paper provides six conceptual building blocs and practical examples for the Matrix Group discussion:

- **Concept Appendix 1** calls upon foundation board members to examine whether foundation assets are in fact invested to maximize risk-adjusted returns. Whereas large endowments can allocate a percentage of the endowment in alternative asset classes such as private equity or hedge funds, smaller foundations often face difficulties in accessing top-decile funds.
- **Concept Appendix 2** argues that financial engineering and investment banking techniques can be equally applied to the funding of civil society organizations and social enterprises, and examines how capital could be allocated more efficiently in the "social capital market." Current capital allocation costs in the US nonprofit sector are very high – between 22%-43%, as opposed to 2%-4% in the for-profit sector.[5] Among other things, this produces fragmentation of initiatives, with less than 0.1% of nonprofits founded in the US in 1970 or after having reached annual turnover of US$ 50 million or more by 2003.[6]
- **Concept Appendix 3** argues that to design appropriate financial solutions, social investors need to understand the fundamental differences underpinning the activities of small and medium enterprises, social entrepreneurs, and microfinance institutions.

[3] *European SRI Study*. Eurosif, 2006
[4] The aspect of down-spending is a growing trend and could also be discussed in the context of achieving greater impact.
[5] Meehan, W. F., Kilmer, D., O'Flanagan, M. "Investing in Society." *Stanford Social Innovation Review*, Spring 2004.
[6] Foster, W., Fine, Gail. "How Nonprofits Get Really Big." *Stanford Social Innovation Review*, Spring 2007.

- **Case Appendix 1** describes the mechanics of one example of financial innovation in the field of social finance, the International Finance Facility for Immunization (IFFIm) Bond. Borrowing against future grant pledges through a capital markets transaction, the GAVI Alliance (formerly known as the Global Alliance for Vaccines and Immunisation) was able to tackle a time-critical public health issue – immunization – prior to the actual disbursement of the funds by donor governments.
- **Case Appendix 2** looks at another example in the field of public health, this time in the sub-Saharan context: the prospects of generating social impact and financial returns via investments in small and medium enterprises – hospitals, pharmacies, vaccine producers, and so on.
- **Case Appendix 3** goes a step further. Single social capital market transactions may be valuable, but mission related investing scale requires the emergence of a liquid market for mission related investments. What kinds of legal frameworks would be needed to enable the creation of such markets?

5. CONCLUSION

The field of foundation finance is currently undergoing profound change, opening up exciting new opportunities that foundation boards may or may not choose to act upon.

Invariably, good decisions are based on appropriate analysis. The authors of appendix 1, Daniel Schwartz and Rafael Meyer, therefore suggest: "At your next board meeting spend the effort looking at the other 95%."

It is our hope that this paper can be helpful as you chart the course of your foundation's investment policy in a rapidly changing environment.

6. CONCEPT APPENDIX 1: A MODEST PROPOSAL – A NEW CALL FOR ATTENTION TO THE OTHER 95%

By Daniel I. Schwartz and Rafael Meyer[7]

The many philanthropists and friends around the world who beyond *noblesse oblige* are deeply committed to making the world a better place are truly inspirational. They exude passion to give back and to make a meaningful and sustainable difference donating significant assets and resources. It is often the desire for continuity and sustainability that leads to the formation of foundations that strive to fulfill the vision of the founders and the boards. Here lies the trap.

The micromotives of macrobehavior are stacked against foundations and charitable endowments when it comes to investment management.

Many foundations spend countless hours debating and deciding to whom to give money. Discussions on grantee identification, selection, management, and efficacy rule the day. Very often effective disbursement of charitable assets is the reason the foundation was created, and the primary interest of the founders and of the board. The desire for sustainability and continuity encourages many boards to distribute annually an amount of the foundation assets that will allow for the near perpetual life of the foundation.

Looking at the numbers it is possible to see that many foundations spend the vast majority of their efforts allocating and distributing assets. The attention, the fun, the passion, and the ardor, are often focused almost exclusively on what, for many foundations, is the 2-5% of the total endowment that gets distributed in any given year. The diligence with which the foundation boards and staff approach this area is often quite remarkable, and I am so often inspired and impressed by the countless hours of deliberation and debate around giving to the right causes. Now what about the often ignored or forgotten 95-98% of assets? What would an extra 1/2% - 2% annual return on the total endowment mean to the overall foundation's potential distribution?

In the foundation world it is quite easy to ignore or forgive sins of omission while vilifying those who perpetrate sins of commission. We rightly criticize and condemn the board members of the charity or foundation who allow the squandering of precious resources. We engage in countless debates around assessing efficacy and impact. We are victims of inertia.

Making money is what is done outside of the foundation, and when it comes to discussions of investment and endowment management, too often we hear "Do not embarrass me," "Do not surprise me" dominating the instructions given to those handling the investments of the endowment.

Investment committees are often charged with "preserving and shepherding the assets" and often not held accountable for maximizing risk adjusted return.

Foundation boards and investment committees fall into a few common traps. One is adopting an ultra-conservative approach to investment management motivated by the correct and honorable desires to preserve assets. Another trap is to treat the endowment's management as a reward to a trusted family member or friend, or to keep a high concentration of assets in a related company or entity, and in many cases without a comprehensive portfolio analysis including risk-adjusted return.

While reputable banks and advisors can elucidate the risks and downsides of the second trap, avoiding the ultra-conservative "no surprises" "no embarrassments" investment strategy is much more challenging.

Inertia is another trap. Why should any of the involved parties be an active agent for change? Who wants to be the banker, board member, investment committee member, or senior staff member who was responsible for any section of the portfolio that underperformed investment returns on the safest investments? The micromotives to be the catalyst for change seem high on the risk side, and low on the individual reward. Since many foundations determine their annual distribution budget based upon a fixed conservative formula often related to the anticipated return on investments in cash and cash equivalents, there is frequently no pressure to adjust this model. Banks and trusted advisors are acting in responsible ways, responding to the stated directives of their clients.

[7] Excerpted from *Viewpoints 2007*, UBS Philanthropy Services, 2007.

Also, when analyzing the very reasons that most donors, board members and staff members became involved with the foundations, love of asset allocation and investment strategy does not appear on the top of the list. I have attended countless board meetings where the organizations who even have a chairperson of the investment committee present, do not spend even 2 or 3% of the time allocated to board meetings discussing management of the endowment portfolio. What results is often lack of a specific mandate for what to do with the money.

An investment committee without the original principals in many cases lacks the right risk takers in the room to properly manage the investments – coupled with dire consequences for any perceived incorrect investment allocation. This recipe often results in an ultra-conservative investment approach.

Additional significant challenges to an investment strategy that attempts to maximize risk-adjusted returns include limited scale and expertise. In many cases the endowment is too small to participate in the opportunities that would be available to investors with a larger asset base.

We call for a modest proposal to foundations. At your next board meeting spend the effort looking at the other 95%.

7. CONCEPT APPENDIX 2: MARKET-BASED SOLUTIONS FOR FINANCING PHILANTHROPY

By Arthur Wood and Maximilian Martin[8]

Introduction

The current structures of international finance provide for two primary formal mechanisms through which funding is directed to address the many social issues across the globe:[9] multilateral governmental models which are resourced through national taxation; and large private grantmaking foundations. But as the pace of globalization increases, these models are proving to be inadequate in their ability to tackle effectively such social issues as education, economic development, health, human rights and poverty.

What are some of the main weaknesses in the system? Whether the amount of funding provided to governments and NGOs for development is enough or too little is hotly debated. Yet almost everyone would agree that a major problem is the distribution and effective use of the money. There is disturbing evidence that this money often does not reach the people most in need, where it is crucial for social change.

Corruption and capital flight are two of the most serious contributing factors to the ineffectiveness of aid transfers. The pervasiveness of corruption and its insidious effects have received increasing attention over the past few years, and there has been recent progress in tackling such practices, albeit too slow for many people. Capital flight is increasingly recognized as a major structural weakness of macro-economic policies. A recent study concludes that between 1970 and 1996 total capital flight from 30 sub-Saharan countries was of the order of US$ 187 billion (in 1996 dollars) .[10,11] As the authors state: "We estimate that for every dollar of external borrowing in the region, roughly 80 cents flowed back as capital flight in the same year... The growth rate differential between the African country and its OECD trading partners is negatively related to capital flight." Such findings point towards the inability of international and national governmental and financial institutions to reform and regulate the capital allocation process transparently and effectively.

Private grantmaking foundations have significantly expanded in scale and visibility in recent years. They are often seen as much better intervention agents given their political independence and their capacity to make more long-term funding commitments. But with the exception of the top philanthropic foundations which in some cases surpass governmental organizations in the scale of their financial support, most foundations operate in a system which is akin to a fragmented merchant banking system. The relationship between demand and supply of finance is institutionally mediated, such that there is no direct connection between social and economic needs and the supply of money. Rather, NGOs, civil society and social organizations have to apply to grantmaking foundations for support, submitting to different concepts of social impact and theories of change.

An individual looking to participate in the philanthropic sector is faced with a bewildering array of players. In many countries the processes of nonprofit registration are complex or ad hoc, and it may not even be possible to identify social purpose organizations. There is often a divide between organizations which are small and operate locally, and those which work nationally or internationally. In either case, it is difficult to assess what the impact of any organization is. Social funding decisions are often based on limited information, personal interest and emotion rather than as part of a strategic approach. This can leave funders frustrated as to how to make their mark on history.

Furthermore, from the perspective of many recipients of financial support – NGOs, nonprofits, social entrepreneurs, philanthropic organizations – there is on-going long-term funding uncertainty. Some grantmaking foundations move with the investment fad of the moment, or depend strongly on the preferences of a key program officer whose departure from the organization can result in funding drying up.

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[8] Excerpted from *Viewpoints 2006*, UBS Philanthropy Services, 2006. See also http://www.ashoka.org/files/Market%20Based%20Solutions%20%28UBS&Ashoka%29.pdf

[9] Individual giving, private remittances and support provided through religious ministries are also significant ways in which monies are transferred from wealthy to poorer countries, though the significance and effects of these are poorly understood at present.

[10] Ndikumana, L., Boyce, J.K. "Public Debts and Public Assets: Explaining Capital Flight from Sub-Saharan African Countries." *World Development* 31(1) pp. 107-130. 2003.

[11] With imputed interest, US$ 274 billion, at end 1996.

Unless we look for creative solutions the current allocation processes will be incapable of addressing the pressing social problems currently experienced through the world.

A Market with Missing Links

Could the mechanisms of the financial market provide solutions to such weaknesses? Looking at the social sector through the capital market lens is helpful: from this perspective the social sector looks like a capital market with a missing link – banks. Missing are banking systems which provide platforms to channel and direct capital flows. The capital market for social finance is substantial: in the US alone this market creates an annual turnover of US$ 1 trillion – and even then there is a considerable annual shortfall. Many organizations with the potential to grow are unable to do so because they cannot tap into an easy-to-access capital market. And almost all nonprofits have to spend too much of their time trying to raise money rather than pursuing their core missions. There are not enough organizations able to systemically expand and strengthen their work in order to really resolve social issues.

Recent research in the US and UK has highlighted the problematic nature of current fundraising practices and relationships.[12] The cost of such bilateral fundraising is viewed by many as too high and can be as high as 43%. This is in addition to the short-term nature of most funding and the complexity of having to manage multiple funding sources with different terms, reporting schedules and monitoring requirements. The commercial banking sector performs the function of the raising of capital in the private sector, providing a more cost effective and more coherent institutional arrangement.

The Emergence of New Allocation Opportunities

There are clear signs of a shift in the allocation of social capital finance – new allocation processes driven mainly by market mechanisms to efficiently target capital to tackling the most pressing and serious social issues. This can be seen practically in a number of ways:

- The global growth of social purpose organizations in the last ten years has not only led to some of the above mentioned problems, but has also resulted in many cases in innovative and cost efficient delivery of social services to the developing world and underprivileged sectors of society at much lower unit cost.
- The growth of social entrepreneurship and similar movements has unleashed the power of creative and ethical entrepreneurship on the social sector, advancing social change with the same entrepreneurial drivers one would see in the private business sector.
- The rise of microfinance solutions, the growth of venture philanthropy and concepts such as triple bottom line investing or sustainability indices have started to introduce new financing mechanisms for social development.

These developments and innovations can be linked to a growing interest in social investment from potential investors. In the US alone it is estimated that the largest transfer of wealth in human history, in the order of US$ 41 trillion, will take place in the next fifty years resulting in a huge social investment potential, connected with the ability to manage capital risk at increasingly smaller capital amounts. There have been changes spurred on by globalization: market models for the social sector have gained much more credibility, globalization has generated new opportunities, driven by the growth of technology, specifically mobile technology. The result is a confluence of social and economic factors encouraging this growth of the market system in philanthropy.

Such factors could encourage banks to enter this huge but inefficient capital market and to perform their core function – the intermediation of capital to the benefit of both their clients and the social capital market.

A Changing View

For this development to accelerate, funders and social investors have to move away from the slightly schizophrenic view that they sometimes hold: as donors, they are often happy to make grants, which

[12] See for example Bradley, B., Jansen, P., Silverman, L. "The Nonprofit $100 Billion Opportunity." *Harvard Business Review*. May 1, 2003; Meehan, W. F., Kilmer, D., O'Flanagan, M. "Investing in Society." *Stanford Social Innovation Review*, Spring 2004; and Unwin, J. "The Grantmaking Tango: Issues for Funders" The Baring Foundation, 2004.

provide an allocation that has a minus 100% return, or zero financial return; while as investors they prioritize how to make financially profitable investments.

This is counterintuitive in investment terms. In terms of market efficiency, clearly the range of "best practice" in social and economic terms would be between these two points. There are certainly some social investments which may never provide a direct positive return in economic terms, though they may contribute to economic progress overall, such as democratic development and the upholding of human rights. But, paradoxically, utilizing skills already available in the capital markets, mechanisms could be created that provide a positive economic return for an investment where the underlying investment loses money.

In the past few years, both institutional and retail investment clients have been educated in a range of financial products with differing economic returns, sometimes even with guaranteed returns. In the institutional space CDOs (Collateralized Debt Obligations) and hedge funds have seen phenomenal growth. In the private client sphere this development has been mirrored in structured and guaranteed products. There is no practical reason why some of these ideas cannot be applied to social and economic return.

Conclusion: Creating the Mechanisms for Market Based Solutions

It is clear that there is an inefficient capital market for social finance at the levels of the state, the nonprofit sector and the private sector. Traditional banks are not involved and the potential efficiencies that the private sector could offer are not currently brought into play in any significant way. At times it seems as if the philanthropic sector relates to the big picture, but primarily operates on a small scale when compared to other sectors of the global economy.

Given the need for market-based solutions, Ashoka has decided to work with others in developing the key elements of a solution. Such a solution must mobilize the substantive knowledge of banks in the field of commercial finance, creating processes that allow the aggregation of capital and the deployment of capital on a scale that will change the nature of social financing. In particular, this requires:

- Creating mechanisms that bring full transparency to the market
- Creating transparency by drawing together players that can aggregate demand on clear platforms – where the risk can be defined to the best available abilities
- Engaging the corporate sector in tandem with the citizen sector, nonprofit organizations, civil society organizations
- Ensuring effective implementation of the processes to social issues
- Defining clear benchmarks of success to allow further injections of capital

Although in their infancy, many of these models and mechanisms are already in existence, either in the private sector or in the philanthropic sector. They need to be brought to scale. This requires cooperation between governmental, commercial and philanthropic sectors, by targeting capital to the people most in need. This will in turn empower people and communities who are currently marginalized. It is time to unleash the power of the market and private capital on the most pressing social issues of our time.

8. CONCEPT APPENDIX 3: INVESTING IN THE EMERGING SOCIAL ENTERPRISE LANDSCAPE

By Maximilian Martin[13]

Introduction

Enthusiasm about a new golden era of philanthropy is widespread and contagious. The reasons are manifold. On the supply side of philanthropic capital, they include trends in growth and holding patterns of wealth, the demographic composition of the group of wealth holders, as well as highly visible commitments from new philanthropists which "up the ante" in the global philanthropic community (think about Warren Buffet's pledge to the Gates Foundation). More and more philanthropists interpret the wise allocation of resources as one of the social responsibilities of wealth, and ask how they can maximize the catalytic effect of their philanthropy to turn the tide on some longstanding social issues. Many view social enterprise as an exciting new conduit for social change.

However, as they seek to translate their aspirations into action they face both structural and "toolbox" constraints which limit the impact of their engagements.[14]

First, the search costs for social investors and investees are extremely high. The problem is structural, the menu of civil society organizations to choose from is large and growing, and the sector suffers from a lack of transparency regarding performance. Thus, one study of the US nonprofit sector puts the combined costs of grantmaking and fundraising as high as 22%-43%, compared to 2%-4% in the for-profit sector, suggesting a generally inefficient capital allocation process in the social sector.[15]

Second, many social investors tend to work with a simple toolbox. They hold a binary view: as donors, they are happy to make grants, which provide an allocation that has a minus 100% return, or zero financial return.[16] By contrast, as investors they prioritize financially profitable investments. From a rational choice perspective, this preference is counterintuitive. In terms of market efficiency the optimal intervention in social and economic terms is a function of the problem the social investor seeks to address, and is likely to fall somewhere between these two binary opposites. Of course, some social investments may never provide a direct positive economic return, though they may contribute to economic progress indirectly, e.g. through democratic development and the upholding of human rights.

Impact-minded philanthropists seek to address both constraints – high search costs and insufficiently sophisticated funding instruments. This article focuses on the latter – "toolbox constraint" – to the optimal allocation of philanthropic capital. Unlike the first, it can be addressed by individual philanthropists or groups of social investors utilizing skills already available in the capital markets. In the past few years, both institutional and private investors have become familiar with a range of financial products with differing economic returns (and even with guaranteed returns). In the institutional space, investment instruments such as collateralized debt obligations (CDOs) and hedge funds have seen phenomenal growth. In the private client sphere this development has been mirrored in structured and capital protection products. These concepts can be applied to social and economic return as well. Done properly, philanthropic capital can help to improve the risk profile of social investments, thus opening up the possibility of drawing additional fresh capital on commercial terms into the business of social change.

However, identifying the appropriate instruments requires understanding underlying sustainability in the emerging social investment landscape.

Mapping Sustainability

"Social enterprise" serves as an umbrella term that is used in many ways. When asking how to best finance a social venture, one first needs to gain clarity about the inherent sustainability of the underlying model. To this effect, a philanthropist can divide potential social investment targets into four sub-categories (see figure 1):

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[13] Article excerpted from *Giving*, Vol. 1, pp. 217-224.

[14] Philanthropists also face many idiosyncratic factors derived from family dynamics or personal giving preferences, which we will not address here for economy of argument.

[15] Meehan, W.F., Kilmer, D., O'Flanagan, M. "Investing in Society." *Stanford Social Innovation Review*, Spring 2004. p. 35.

[16] Wood, A., Martin, M., "Market-based Solutions for Financing Philanthropy." *Viewpoints 2006*. UBS Philanthropy Services, 2006.

- *Small and medium enterprises with a demonstrated social impact*. These are typically real-sector for-profit companies that create both social and economic benefits[17] – e.g. by offering jobs in particularly depressed areas, or producing goods and services that carry positive externalities so that they need not be imported in sectors such as healthcare.
- *Social entrepreneurs who provide private goods*. These are typically mission-driven real-sector for-profit or not-for-profit organizations that create both social and economic benefits.
- *Social entrepreneurs who provide public goods*. These are typically mission-driven real-sector not-for-profit organizations that mainly create social benefits.
- *Microfinance institutions*. Microfinance institutions work in the financial sector and create both economic and social benefits. Ranging from very small non profit associations to large commercial banks, they share a mission to serve the poor by extending very small loans and other products to either the unemployed, poor entrepreneurs or to others living in poverty that are not bankable. Such organizations can be incorporated under a variety of different legal statuses, including as foundations, cooperatives, credit unions, non-bank financial institutions or fully fledged banks.

Category	Example	Sector	Type of benefit	Investment solution	Opportunity
Small-Medium Enterprises	Prime Cure	Real	Economic + Social	Equity or loan deals	Theme funds
Private good SEs	Aravind	Real	Economic + Social	Loan deals + Technical Assistance	Loan funds (e.g. irrigation, housing)
Public good SEs	International Bridges to Justice	Real	Social	Grant + Technical Assistance	Donor collaboratives
Microfinance Institutions	Acción	Financial	Economic + Social	Equity or loan deals	Second tier funds

Figure 1: Disaggregating Social Enterprise Investment Opportunities

Figure 1 suggests that grants are the most effective form of financing for social entrepreneurs ("SEs") who conduct activities that cannot reasonably be expected to ever become financially self-sustainable, because they provide social benefits rather than economic benefits. Applying economic theory, we can refer to them as *public-good social entrepreneurs*.

By contrast, some small and medium enterprises, microfinance institutions and social entrepreneurs provide "private goods." They create a substantive economic benefit for their constituents. These organizations should be able to monetize a part of the benefits created to cover costs. This is the idea behind microfinance – and indeed, some microfinance institutions have returns on equity equivalent to or higher than some of the most successful large banks. Experience shows that a mix of capacity-building grants and for-profit investments is the most effective way to support *private-good social entrepreneurs*.

[17] The "real sector" refers to economic activity in the primary (agriculture), secondary (industry) and tertiary (services) sectors, except financial services.

Public-Good Social Entrepreneurs

Small and medium enterprises and microfinance institutions are familiar concepts. But what is the difference between social entrepreneurs providing public and private goods? Let us look at two examples.

Partnering with local organizations around the world, Witness, a US nonprofit organization, works to get video cameras and cell phones into the hands of human rights activists. Recorded images serve to focus public attention on human rights abuses. Witness thus enables human rights defenders to make human rights violations visible. This transforms personal stories of abuse into systematic tools of justice. In short, Witness is in the business of providing a public good. Every citizen benefits substantially if a government uses its monopoly of legitimate use of violence to uphold human rights. However, it is difficult to see how an advocacy-enabling civil society organization could monetize the benefits it creates. This means that earned income derived from core activities is unlikely to assure self-sustainability. Organizations such as Witness may be run more or less efficiently, or they may own businesses that provide an income stream – but for their core activities, they will always depend on a subsidy which is likely to take the form of a grant, if it comes from a philanthropist, or a public contract. In areas such as human rights, even organizations that assist governments in implementing the human rights legislation they passed are likely to need some subsidies. For example, Geneva-based International Bridges to Justice (IBJ) works with governments to enhance their criminal defender and legal aid efforts (cf. www.ibj.org). Through providing training partnerships, legal and administrative structural support, and material assistance, IBJ aims to protect citizen rights and accelerate the implementation of existing criminal laws. This provides some earned-income streams, but full self-sustainability from core activities is difficult to envision.

Private-Good Social Entrepreneurs

The picture differs completely in the case of small and medium enterprises, private-good social entrepreneurs, and microfinance institutions. These are potentially profitable organizations that choose to operate in a social enterprise mode. Take the story of providing low-cost cataract eye operations.

In the 1980s, David Green, who later became an Ashoka Fellow, successfully raised large volumes of in-kind donations of intraocular lenses (IOLs) from US manufacturers to perform cataract operations at the Aravind Eye Hospital in India (cf. www.aravind.org, www.aurolab.com). This provided a core input necessary to scale the number of eye operations. The second driver was a redesign of the surgery process along the lines of scientific management, creating a low-cost eye operation chain with standardized, quality outcomes. People who need a cataract operation and are able to pay for it will do so. Providing cataract surgery is more like a business than a public good. Rather than grants, it needs investment.

When Aravind's in-kind donation stream of IOLs dried up in the late 1980s due to a change in industry dynamics, the high cost of IOLs in the open market in excess of US$ 125 became a constraint. In response, David Green established a non-profit organization, Aurolab, as the manufacturing division of Aravind Eye Hospital. In a remarkable exercise in technology transfer, Aurolab managed to manufacture high-quality IOLs at affordable prices – about US$ 5 a pair. Since 1992, Aurolab has supplied over 5 million lenses to its customers in India and over 120 other countries worldwide. Given its low cost base and secure access to core components, the Aravind cataract operation business is in principle very profitable. Today, Aravind treats about two-thirds of its patients for free. The remainder effectively subsidizes those who are not able to cover the full cost of the operation.

Human rights and health are both of fundamental importance for society. But the financing challenge of the cataract business differs structurally from that of human rights advocacy. Globally 37 million people are blind and approximately 150 million people have serious visual impairment. There is demand for numerous Aravind-like inherently sustainable eye care systems. Once the Aravind Eye Care system ran smoothly, David therefore began to consult to other eye care systems around the world to enable them to become self-sustaining. Since 2000, this has allowed over 120 eye care programs globally to become profitable while offering quality services to the wealthy and the poor alike via price discrimination schemes. Properly run and scaled, such programs generate sufficient cash flow to support debt financing at manageable levels of risk. In principle, they should be able to access capital markets on commercial or quasi commercial terms. To this effect, David Green recently set up an Eye Fund that provides loans to eye care systems.[18] In this mechanism, commercial investors receive a rate of return

[18] Ashoka has played a key role in supporting David Green in this endeavor, seeking to create intermediaries that see a value in collaboration across civil society organizations to overcome the traditional fragmentation in the sector.

above the risk-free market rate, and US foundations that make program-related investments (PRI) receive lower returns commensurate with PRI instruments. This brings fresh, non-grant capital to the table.

Applying the tools of investment banking can reduce the transaction costs of capital allocation through the creation of funds with various tranches of target returns and risk exposure and collateralized debt obligations. In principle, a wide range of investment instruments above or below risk-adjusted market returns is conceivable.[19] In practice, the single most important constraint to draw additional financial resources into financing private good social entrepreneurs is the challenge of identifying, characterizing and qualifying pools of possible investments and then aggregating them into sufficiently large capital pools to meet the minimal size requirements for the financial services industry. Mainstreaming supply aggregation requires designing mechanisms to uncover quasi-vetted deal flow of investment opportunities in private-good social entrepreneurs.

Given that such funding mechanisms are new in the field of social entrepreneurship, a look at financial innovation in the field of microfinance can provide a sense of their likely future relevance. In the context of a sizeable and growing microfinance market, the sophistication of funding mechanisms has progressed substantively in the past ten years. The 2005 Micro-Credit Survey acknowledges over 3,164 microfinance institutions reporting over 92 million micro-enterprise clients worldwide, of which over 70% are among the poorest.[20] Its 2000 survey reported market data at one third of its current size. Many specialized fund management boutiques and fund advisers have emerged, offering various tailored products for specific groups of investors. Some global banks have also started their own funds, either internalizing the specialized management function or externalizing it. Innovative transactions include taking first-loss positions in collateralized debt obligations and securitizations or guaranteeing bonds and local debt loans.

Conclusion

Transferring the microfinance experience to social enterprise in general, it is likely that financial innovation in the social enterprise space will create exciting new opportunities to leverage philanthropists' scarce resources. By funding first-loss tranches or issuing guarantees, they can serve as a catalyst to bringing additional commercial capital to the table. The mechanics differ depending on asset class.

- For small and medium enterprises in specific world regions and sectors such as healthcare or construction that have a demonstrated social impact, themed equity and loan funds can be promising.
- To supply private-good social entrepreneurs with capital, philanthropists can resource a mix of loan and technical assistance funds.
- Public good social entrepreneurs require grant and technical assistance funds.
- In the field of microfinance the great challenge is to seed fund the next generation of early-stage microfinance institutions, taking them to profitability. This might require some additional risk appetite, given the fact that current mainstream inflows into microfinance tend to be mainly allocated to top-tier microfinance institutions, while second-tier institutions often face growth constraints due to lack of risk capital.

However, realism is required. Many challenges remain concerning the design of specialized financial products to finance public and private good social entrepreneurs. They include cost-effective due diligence processes, the identification of a critical mass of reliable deal flow, as well as technical challenges regarding product design.

The experience of microfinance shows that to operate at a reasonable scale and risk characteristics, most for-profit social investment opportunities require philanthropic capital somewhere in the background, be it in the form of technical assistance and capacity-building grants, or of first-loss commitments or loan guarantees that transform junk paper into investment grade. In the field of microfinance, international financial institutions such as the International Finance Corporation (IFC) as

[19] Martin, M. "Aggregating Demand, Targeting Impact." *Viewpoints 2007*. UBS Philanthropy Services, 2007.
[20] Daley-Harris, S. "State of the Microcredit Summit Campaign Report 2005." Microcredit Summit Campaign, 2005.

well as private philanthropists had to provide such philanthropic capital for years, before a market for microfinance capital on commercial terms could emerge.

As we look ahead, we also need to keep in mind that designing more effective financing mechanisms for social enterprise is not just a technocratic exercise. Philanthropy has an experiential dimension. While the design of transaction-cost minimizing transmission mechanisms for philanthropic capital is an important challenge, it would be a mistake to view effective philanthropy exclusively from a technocratic perspective. As David Rockefeller pointed out in an interview in the Chronicle of Philanthropy in 2006, "the impulse to participate in philanthropy comes from the heart, not just from the mind. It will be much less well done if it is just an intellectual conviction." Any scaleable solution to efficiently fund social enterprise is therefore likely to provide an effective combination of what one can refer to as "the relational element in philanthropy" with sophisticated financial engineering.

9. CASE APPENDIX 1: FRONTLOADING RESOURCES THROUGH FINANCIAL ENGINEERING – THE INTERNATIONAL FINANCE FACILITY FOR IMMUNIZATION

By Maximilian Martin and Tim Nielander[21]

Context

As pointed out in the concept appendices 1-3, there is no practical reason why the techniques and concepts of investment banking and capital markets cannot be applied to solving some of the most pressing social challenges of our times. This case appendix describes the mechanics of addressing one such challenge in scale through the tools of financial engineering by borrowing against future grant pledges to be able to tackle a time-critical issue – immunization – prior to the actual receipt of the pledged funds.

The Challenge: Financing Immunization

The fourth Millennium Development Goal (MDG) is the reduction by two thirds of the mortality rate of children under five by 2015. Immunization programs are a key element of a strategy to achieve this MDG, yet successful and comprehensive immunization remains a challenge. The World Health Organization (WHO) estimates that 27 million infants were not reached by the DTP3 vaccine in 2003 and are not vaccinated against common childhood diseases including diphtheria, tetanus, hepatitis B, yellow fever, measles and polio.[22] The previous year, an estimated 2.1 million people around the world died of vaccine preventable diseases, including 1.4 million children under the age of five. Many more fall sick, miss school and become part of the vicious cycle that links poor health to continued poverty in adulthood.

The GAVI Alliance was created in 1999 with an initial grant from the Gates Foundation, to address the needs for vaccines and immunization in the world's poorest countries (with a per capita gross national income of less than US$ 1,000). It is a public-private partnership between multiple agencies (WHO, UNICEF, the World Bank, industry representatives, the GAVI Fund, and donor and recipient governments). GAVI channels funding to support introduction of new vaccines as well as immunization programs for existing but underused vaccines. Other areas of activity include strengthening health systems, infrastructure, and education. GAVI has implemented an innovative performance-based grants program that rewards countries for increasing immunization coverage and since 2000 has committed more than US$ 1.6 billion to more than 70 of the world's poorest countries. Yet, overall funding remains insufficient to provide complete coverage to the world's poor, and most countries are expected not to meet this or other key MDGs, unless new funding becomes available.

The Solution: Borrowing Against Future Grant Pledges

To address the funding gap, the International Finance Facility for Immunisation (IFFIm) was proposed in 2004 as an independent development institution to generate finances to support GAVI's immunization programs. Formally established in 2006 as a charity registered with the Charity Commission for England and Wales, the IFFIm has the goal to generate up to US$ 4 billion for programs from 2006 to 2015 (inclusive). It provides funding proceeds to the GAVI Fund Affiliate, likewise a registered charity tasked with disbursing funding proceeds in support of approved GAVI programs. GAVI is responsible for the operational activities related to the immunization and/or vaccine procurement programs for which IFFIm funding is provided.

[21] See also http://www.iff-immunisation.org/key_prog_docs/dealer_agree3Nov06.pdf, http://www.iff-immunisation.org/pdfs/pr_nov7b_06en.pdf, http://www.iff-immunisation.org/pr_nov7_06en.html

[22] http://www.who.int/mediacentre/factsheets/fs288/en/index.html

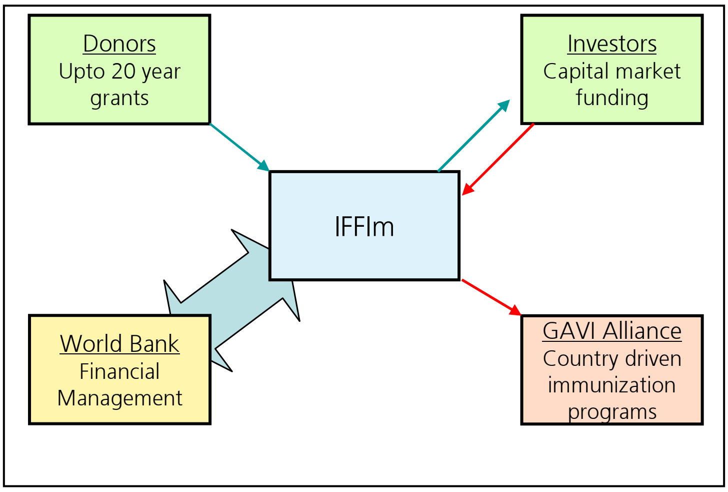

Figure 2: Structure of the IFFIm and Partners

Donors	**Grant amount (millions)**
UK	£ 1,380
France	€ 372.80
Italy	€ 473.40
Spain	€ 189.50
Sweden	SEK 276.1
Norway	US$ 27.0
Total (initial)	US$ 4,000
France	Up to €920
Brazil	US$ 20
South Africa	US$ 20
Total (initial & incremental)	**US$ 5.2 billion**

Figure 3: Commitments to the IFFIm (initial and incremental)

The IFFIm operates by raising capital from the international capital markets by borrowing against future grant pledges (see figure 2). At establishment, France, Italy, Norway, Spain, Sweden and the UK each provided binding donor commitments to the IFFIm totaling US$ 4 billion, with Brazil and South Africa later committing additional funds (see figure 3).[23] Given the pledges of donor governments, and IFFIm's association with the World Bank, IFFIm can raise capital on commercial terms with a "AAA" credit rating. Over the course of 10 years, the IFFIm will raise up to US$ 4 billion depending on the needs of immunization programs in GAVI countries. Fund raising will be done through sale of bonds to retail and institutional investors through a variety of transactions ranging from larger, more liquid issues to smaller targeted bonds.

The WHO estimates that IFFIm’s resources could lead to the vaccination of more than 500 million people over the next ten years, with the objective of preventing the deaths of 5 million children and 5 million adults via the usage of new and under-utilized vaccines, targeted immunization campaigns and the strengthening of health and immunization services in GAVI’s target countries.

Conclusion: Beyond the Bond Program to Support GAVI

In November 2006, the IFFIm released its first bond issue (5 IFFIM 11, SWX), to raise US$ 1 billion through notes at 5% interest due on 14 November 2011. Interest is payable annually, and the notes received the highest credit rating (AAA) from all three major credit rating agencies (S&P, Moody's, and Fitch). The issue was lead managed by Deutsche Bank and Goldman Sachs, with eight of the largest financial institutions as co-lead managers to the issue (including UBS Investment Bank).

The release and successful closure of this issue allowed IFFIm to leverage donor commitments to "frontload" its portfolio by raising commercial capital against those donor pledges. The bond program to support GAVI is a significant innovation.

The mechanics can in principle be applied to other social challenges as well as mapped by the Millennium Development Goals. Take, for example, the upcoming UN Year of Sanitation 2008. The Millennium Development Goals set a target of reducing by half the 2.6 billion people without sanitation by 2015. Lack of access to basic sanitation causes widespread water borne diseases with significant adverse socio-economic implications. According to the World Health Organization, 3.5 million people die every year from diarrhea and other water related diseases, of which 80% are children between six months and five years of age. Addressing this challenge requires, conservatively, US$ 10 billion every year. In principle, a structure similar to the IFFIm could be deployed to finance the scaling of global sanitation solutions.

[23] "Credit Analysis Report, International Finance Facility for Immunisation." FitchRatings, September 2006.

10. CASE APPENDIX 2: INVESTING IN HEALTHCARE DELIVERY – IDENTIFYING POINTS OF LEVERAGE

By Maximilian Martin

Context

Concept appendices 1-3 argue that the techniques and concepts of investment banking and capital markets are applicable to solving social challenges. Case appendix 1 highlights how one such challenge – immunization – was addressed by means of a bond issue that translated donor commitments in the future into financial resources available today.

Immunization requires immediate action – so borrowing against future income streams to be able to act today makes sense. But public health efforts are also greatly helped by strengthening the health clusters in the target countries. Therefore, this case appendix looks into the potential of financial tools to conduct investments in small and medium enterprises – hospitals, pharmacies, vaccine producers, and so on – as another opportunity to make a difference in the field of public health.

The Challenge: Building Public Health

There is a growing health divide between industrialized and developing countries. This is particularly true in Africa, which hosts 10% of the world's population, 24% of the global disease burden (in sub-Saharan Africa), but accounts for only 3% of the worldwide healthcare workforce. According to the World Bank under-five mortality is five times higher in middle-income countries than in rich countries and fifteen times higher in low-income countries. Child mortality from malaria doubled between 1991 and 2001, with the largest increase in sub-Saharan Africa. And while quick gains have been possible in child health in the past few years, overall life expectancy in sub-Saharan Africa has not improved much – it was 40 years in 1980, 50 years in 1990, and stagnant at 46 years between 2001-2003.[24]

In sub-Saharan Africa public healthcare systems are overburdened and public health expenditures insufficient. On average OECD countries spent 9.7% of GDP on health in 2002, with the US spending as much as 15% (in 2004). In comparison, the overall figure for Africa was 5.1% and even lower for many sub-Saharan countries.[25]

The good news is that the bulk of the disease burden in poor countries is preventable. The past 10 years have seen a massive expansion in health spending by donors, often targeted at specific diseases and technical interventions such as new drug and vaccine development. The Global Fund, for instance, spent 48% of its round 6 expenditure on drugs and commodities, and 11% on infrastructure and equipment.[26] The GAVI Alliance, discussed in **case appendix 1**, successfully raised US$ 1 billion and is committed to developing new vaccines.

At the same time, coverage of established vaccines is stagnating. For example measles coverage has been stuck at 60-70% in sub-Saharan Africa since the start of this decade. For all vaccines, vaccination rates in Africa remain well below the global average.[27] This suggests that addressing the health crisis in developing countries, and particularly in Africa, requires two things:

- The development of new solutions
- Investment in the healthcare systems that can deliver such solutions to the population

The financing of new solutions was the subject of the previous appendix. This appendix focuses on the second challenge – directing investment to points of leverage to strengthen healthcare systems.

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[24] World Development Indicators Database, World Bank.

[25] Poullier, J., Hernandez, P., Kawabata, K., Savedoff, W.D.,"Patterns of Global Health Expenditures: Results for 191 Countries." EIP/HFS/FAR Discussion Paper No. 51. World Health Organization. November 2002.

[26] http://www.theglobalfund.org/en/funds%5Fraised/distribution/#sector_recipients

[27] World Health Organization. "Measles-containing Vaccine: Reported Estimates of MCV Coverage," 2006. http://www.who.int/immunization_monitoring/en/globalsummary/timeseries/tscoveragemcv.htm.

The Solution: Identifying Points of Leverage in Healthcare Delivery

Across Africa countries generally have a three-tiered public health system with basic clinics at the first level, district level hospitals at the secondary level, and referral and specialty hospitals at the tertiary level. A large segment of the population resides in rural areas, but the primary level only receives a small segment of health expenditures. Healthcare personnel tend to be concentrated in urban areas.

This delivery structure entails three important implications and suggests that strengthening private healthcare delivery clusters constitutes a point of leverage where scarce resources can create disproportional impact:

- First, spending and need are imperfectly aligned. A study by the World Health Organization identified that a majority of causes of illness and death in all seven African countries studied were preventable and treatable.[28] In Madagascar it was estimated that 90% of illnesses could be prevented or treated at the primary level. Yet, the primary level received only 25% of health spending.
- Second, it is the wealthier citizens – not the poorest – that tend to benefit from the public health system. This is partly because health facilities are better in urban, rich areas. As the study showed, the best-off groups use mainly publicly subsidized healthcare (except in South Africa). In Ghana the richest quintile directed almost 60% of its health spending to the public sector. By contrast, while the poor were much less likely to seek medical help, when they did they turned to the private sector simply because it was more accessible (see figure 4).

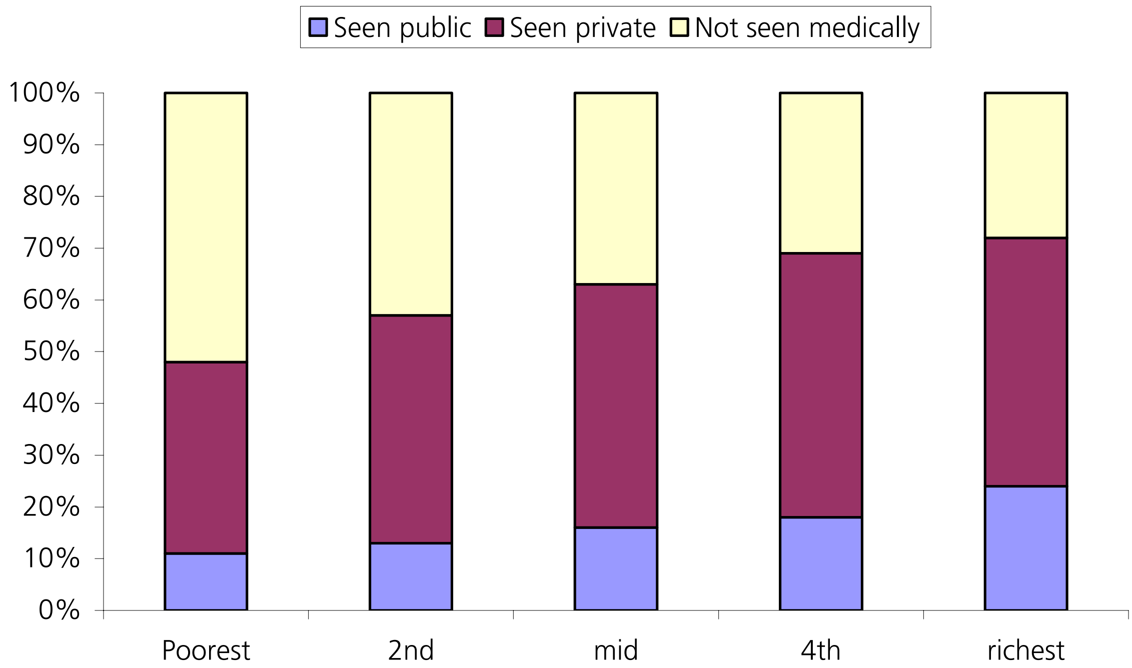

Figure 4: Distribution of acute respiratory infection cases by type of provider sought according to socio-economic groups in rural Uganda[29]

[28] Castro-Leal, F., Dayton, J., Demery, L., & Mehra, K. "Public Spending on Health Care in Africa: Do the Poor Benefit?" *Bulletin of the World Health Organization*, 2000.
[29] Prata, N., Montagu, D. "Improving Innovative Health Care Delivery Systems That Serve the Poor." Paper submitted to the IUSSP Conference. Undated.

- Finally, private sector health spending is substantial. While public sector health services account for a varying but substantial portion of healthcare *delivered*, the private sector accounts for a significant portion of health *spending*. The IFC estimates that over 50% of health spending across Africa is directed at private sources, and a majority of spending is out-of-pocket. In select countries it is even higher (see figure 5).[30]

Country	Government & donors	Private (OOP)	Total
Mauritania	8 (26%)	23 (74%)	31
Guinea	3 (9%)	31 (91%)	34
Burkina Faso	9 (43%)	12 (57%)	21

Figure 5: Yearly health expenditures by source. US$/inhabitant (%)

Conclusion: Investing in Private Healthcare Delivery Systems

The preceding analysis suggests a conclusion that seems counterintuitive at first sight. Public sector healthcare does not optimally target the poor, and top-quintile citizens receive a larger proportion of the overall health subsidy in most African countries studied.[31] By inference, private-sector healthcare delivery solutions may be more easily geared to serving the poor, and scaling private-sector healthcare delivery could be a real opportunity.

Experience with existing private healthcare delivery systems around the world also suggests that serving low-income households in scale is possible. For example, the Aravind Eye Care System and Aurolab in India provide cataract surgery on an industrial scale, with two-thirds of all surgeries conducted free, as described in **concept appendix 3**. Franchisee models in Africa could be just as promising.

- For example, in Kenya, the HealthStore Foundation franchises shops and clinics for low-income patients that today serve 400,000 patients per year in underserved rural and urban areas. Of the 64 locations, 70% are profitable. The franchise model allows for low-cost sourcing of high quality drugs, uniform branding, and centralized management of political and regulatory issues, economies of scale and sharing of best practices.[32]
- In South Africa, PrimeCure provides affordable healthcare, serving over 1,000,000 patients across the country.[33] The core of its business – managed care – offers three tiers of insurance to low- to middle-income customers. PrimeCure rates are about 50% less than normal rates because it manages costs and quality internally.

Typically, government and multilateral donor funding of healthcare targets the public sector. Corresponding private investments into the healthcare sector are largely absent. There are many investment funds active in developing countries, and Africa. While some investment funds are focused exclusively on the health sector, there are no such funds investing in Africa that exclusively target private sector healthcare delivery. Yet, private sector healthcare clusters in sub-Saharan Africa could be strengthened substantially by appropriate financial investment.

Providing access to expansion stage capital could accelerate the ability of private healthcare to deliver in scale. Transferring expertise from venture capital and microfinance, financial innovation is likely to create exciting new opportunities to build public health in sub-Saharan Africa. For example, providing technical expertise to small and medium enterprises active in private healthcare delivery paired with funding first-loss tranches or issuing guarantees can serve as a catalyst to bringing additional

[30] Marek, T., O'Farrell, C., Yamamoto, C., Zable, I. "Trends and Opportunities in Public-private Partnerships to Improve Health Service Delivery in Africa." International Finance Corporation, 2005.

[31] Castro-Leal, F., Dayton, J., Demery, L., Mehra, K. "Public Spending on Health Care in Africa: Do the Poor Benefit?" *Bulletin of the World Health Organization*, 78 (1), pp. 66-74, 2000.

[32] See http://www.cfwshops.org/overview.html

[33] See http://www.primecure.co.za/

commercial capital to the table. The key question is: How can social investors design mechanisms to unlock commercial capital and expertise to solve this challenge?

11. CASE APPENDIX 3: UNFREEZING THE FOUNDATION ASSET LANDSCAPE TO CREATE A LIQUID SOCIAL CAPITAL MARKET – THE LOW-PROFIT LIMITED LIABILITY COMPANY (L3C)

By Maximilian Martin and Arthur Wood

Context

Concept appendices 1-3 explain how the techniques and concepts of investment banking and capital markets can be brought to bear on developing scalable financing solutions to social challenges. Case appendices 1-2 take the example of public health to explain how financial tools can be used to translate future donor commitments into funding today, and how private investment into healthcare clusters can serve as a point of leverage to address public health challenges.

We will now shift gears. How can foundation assets be invested for greater social impact without sacrificing financial return objectives – for example, by investing in social enterprises? And why is this relevant? In organizing the socioeconomic activity outside the public sector two options are generally available. At one end of the spectrum, businesses usually incorporate as privately held, profit-maximizing entities. At the other end, organizations that have a charitable purpose incorporate as non-profit entities. By giving up the profit motive and adopting a social purpose these non-profits are endowed with special privileges such as exemption from taxation in many jurisdictions. This fundamental differentiation has remained in place for several decades, during which the social sector has grown immensely in scale and ambition. Today it functions not only in niche areas, but with support from private philanthropists and individuals is pushing the barriers of social service provision. Social enterprise has emerged as the new frontier and typically relies on market mechanisms to work toward goals that are not purely or even primarily financial.

The Challenge

Social enterprises face multiple challenges in becoming main stream but access to capital is currently the binding constraint. This was the conclusion of a meeting at the Aspen Institute in September 2006 that examined social enterprises' difficulty under present laws to attract investment capital, whether from bank loans, venture capital, or in some other form.[34]

Two primary sources of capital are conceivable: commercial and philanthropic. However, commercial capital often avoids social enterprises, partly because of lower target returns and the greater difficulty of conceptualizing business models that generate both social and financial returns in the language of the capital markets.

Thus, charitable foundations emerge as a potentially major source of capital. Foundation endowments have grown substantially in past decades. The Foundation Center estimates that in the US alone, the combined assets of grant-making foundations grew from US$ 30 billion in 1975 to US$ 227 billion in 1995 and about US$ 510 billion in 2004 (in 1975 dollars)[35] – a compound annual growth rate of nearly 10%.

Currently, charitable foundations seeking to invest in social enterprises with such "hybrid" returns face a specific set of challenges, which are largely regulatory. For example, under US tax laws non-profit foundations can make "program related investments" (PRI) into such profitable organizations that further the charitable cause of the foundation. PRI investments are beneficial to a foundation as they count as part of the required 5% payout and are not booked as part of the endowment. This means they do not count towards calculation of the next year's 5% payout requirement and any capital gain is not included in the excise tax. So PRI investments, unlike regular endowment investments, are a kind of "off the books" investment – to be dealt with only when they earn income or are sold. Even then, rules are simple – any income or gains must be given away or reinvested in another PRI within the same year in addition to the 5% already allocated for that year.

Despite these many benefits, PRIs have not been widely adopted in the US. Why? To safely qualify as a PRI, an investment usually requires a "private letter ruling" from the Internal Revenue Service (IRS), which certifies the investment as PRI. Obtaining such a ruling, however, often requires expending significant time and cost.

[34] Billitteri, J. "Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?" The Aspen Institute. January 2007.
[35] http://foundationcenter.org/findfunders/statistics/pdf/02_found_growth/06_04.pdf

The Solution: Developing PRI-friendly Legal Vehicles

How can the transaction costs of investing foundation assets in social enterprise be reduced? Several initiatives are under way to address this challenge. Here are two examples from the US and the UK.

- **The Low-Profit Limited Liability Company (L3C)**:[36] Recent moves, initiated in North Carolina, USA by the Mannweiler Foundation, and supported by Ashoka, GAVI, and others, aim to create an institutional context for PRIs – the low-profit limited liability company (L3C). An LLC is a privately held corporation owned by members with limited liability. The L3C would be a specific type of LLC, that would operate a profit-making business, but one with a charitable goal. The requirements for an L3C would match *exactly* the conditions placed on PRIs in IRS tax law, obviating the need for a private letter ruling and attracting foundation investments. However, as a company, the L3C would also be able to access capital markets.
- **Community Interest Companies (CIC)**:[37] In 2006, the UK established a new limited company type called the Community Interest Company. CICs have special features, created for the use of people who want to conduct a business or other activity for community benefit, and not purely for private advantage. Through certain qualification tests (community interest test) and an "asset lock," regulations ensure that the CIC is established for community purposes and the assets and profits are deployed accordingly. However, a CIC can have both non-profit and for-profit member ownership, allowing it to work across the spectrum.

Conclusion

The initiatives under way take into consideration that there are organizations that create both a strong social benefit and an economic return. However, in so doing, these initiatives also provide the additional benefit of creating opportunities to unfreeze the foundation asset landscape. One of the likely by-products of the L3C in particular would be to significantly expand PRIs into a viable social capital market for two reasons:

- **Layered investing**: As an LLC an L3C can distinguish between its members. This allows different entities to buy memberships with different levels of return and risk. For instance, philanthropists could buy the highest-risk membership of an L3C from the grant component of their portfolios, while a small foundation may buy the lowest-risk membership of the same vehicle from its bond component. This layering would allow a variety of investors to participate in L3Cs, depending on their risk preference, expanding capital available.
- **Transparency and tradability**: Initiatives such as the CIC increase the transparency of social enterprises by requiring annual reporting, a major precondition for the development of a viable secondary market for such investments. Once tradable, such securities would make the PRI market more liquid, again encouraging greater participation. This would apply even for foundations that do not have matching mission investments, since they could provide backing to investments of smaller foundations.

The two initiatives discussed above address the immediate lack of regulation and definition for social enterprises as for-profit charitable entities. However, they are important for a more fundamental reason. By institutionalizing the concept of a "for-profit social enterprise", they recognize that organizations can reconcile the twin goals of social impact and financial return. The acceptance that this is possible expands the possibility frontier for funding social enterprise, both from commercial and philanthropic sources. Just envision a campaign where one year of annual payouts or 5% of the overall US foundation assets would be invested in social enterprise – and over US$ 20 billion in additional funding for social enterprise would come on stream![38]

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[36] "The L3C: The For-profit with a Nonprofit Soul." Mannweiler Foundation Inc., 2007.

[37] http://www.cicregulator.gov.uk/index.shtml

[38] Europe has a sizeable foundation sector as well. The largest 50 European foundations have cumulative assets of €147 billion – roughly comparable to the assets of the top 50 American foundations, with assets of €133 billion. *European Foundations: Report on Top 50*, Watson Wyatt. February 2007.