

Lending to Charities: Stop, Look, Listen, Think

Much like crossing the road, lending to charities can be hazardous but is straightforward if you know what to look for. This briefing note has been designed to enable lenders to navigate their journey with maximum safety and ease.

Overview

The critical point for lenders is to understand the distinction between a charity's restricted and unrestricted funds. It is this classification which determines whether the lender should discount certain funds or assets of the charity when making any credit assessment.

A charity's unrestricted funds are not ring-fenced for any particular charitable purpose and can, therefore, usually be included in the lender's credit assessment. Unrestricted funds will include 'designated funds'. These are funds which the trustees have themselves designated for a particular purpose or project. This is for administrative purposes only. Designated funds are, therefore, unrestricted and expendable and they should be included in a credit assessment.

A charity's restricted funds are reserved for a specific charitable purpose and are not usually suitable to include in a credit assessment.

Restricted or Unrestricted?

It is the terms of the relevant grant, gift or legacy which determine whether funds are restricted or unrestricted.

In general, restricted funds fall into two categories:

- 1) *Restricted income funds* have their use restricted to a particular purpose such as where an individual gifts money to a charity to be used for a specific purpose.

- 2) *Endowment funds* have their use restricted to deployment as a capital investment such as where a gift of money or assets may only be applied to acquire a specific piece of land.

Endowment funds can be permanent (retained by the charity indefinitely) or expendable where the charity has the power to convert the capital element of the asset into an income fund. Unless otherwise stated in the terms of the grant, gift or legacy the income produced by a permanent endowment (such as rent or dividends) is unrestricted.

Lenders, therefore, need to be alive to the terms of the grant, gift or legacy and, crucially, to the presence of any income derived from restricted funds which may itself be unrestricted.

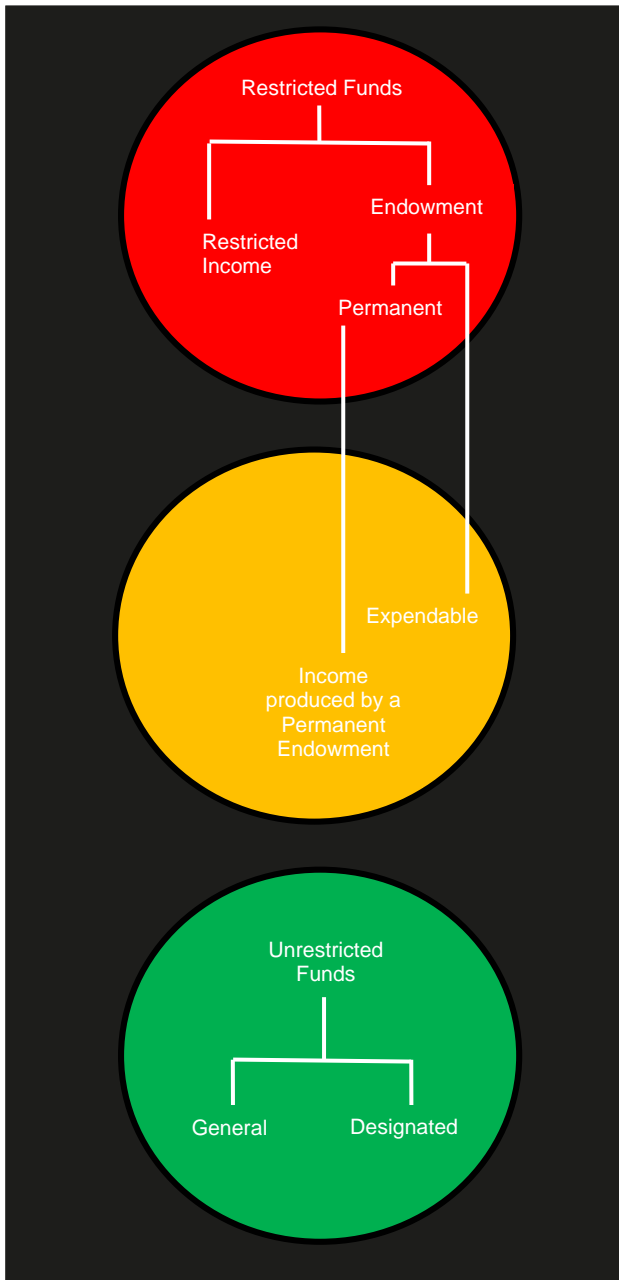
Charitable Powers

While a charity may have the power to grant a security over assets categorised as a permanent endowment, lenders should be very wary of accepting security over such restricted-use assets. In this case, the lender must undertake thorough due diligence on the powers of the charity to grant this security and the terms of the restricted funds.

Avoiding Accidents

So 'stop, look, listen, think' is as relevant to lenders or investors as it is to crossing the road. Restricted funds should be clearly identified in a charity's report and accounts together with brief details regarding the terms of any restriction. Further analysis may, however, be required to avoid erroneous decisions to lend to or invest in a charity which may be distorted if restricted funds or assets are wrongly taken into account.

The Traffic Light Formula: Classes Of Charitable Funds



STOP!
These funds should not be included in the credit risk assessment.

WAIT!
These funds could be included in the credit risk assessment but further investigation is required.

GO!
These funds should be included in the credit risk assessment.

Technically Speaking...

<p>Designated Funds</p>	<p>Unrestricted funds are expendable at the discretion of the trustees in furtherance of the charity's objects. If part of an unrestricted fund is earmarked for a particular project it may be "Designated" as a separate fund, but the designation has an administrative purpose only, and does not legally restrict the trustees' discretion to apply the fund.</p>
<p>Expendable Endowment</p>	<p>An "Expendable Endowment" fund is a fund that must be invested in capital to produce income. Depending on the conditions attached to the endowment, the trustees may have a legal power to convert all or part of it into an income fund which can then be spent.</p> <p>An expendable endowment differs from an income fund in that there is no actual requirement to spend the principal for the purposes of the charity unless or until the trustees decide to. However, income generated from expendable endowment is no different from income generated from permanent endowment, and should be spent for the purposes of the charity within a reasonable time of receipt.</p>
<p>Permanent Endowment</p>	<p>"Permanent Endowment" is property of the charity (including land, buildings, cash or investments) which the trustees may not spend as if it were income. It must be held permanently, sometimes to be used in furthering the charity's purposes, sometimes to produce an income for the charity. The trustees cannot normally spend permanent endowment without Charity Commission authority.</p> <p>The terms of the endowment may permit assets within the fund to be sold and reinvested, or may provide that some or all of the assets are retained indefinitely (for example, a particular building).</p>
<p>Reserves</p>	<p>"Reserves" (unless otherwise indicated) describe part of a charity's income funds that are freely available for its general purposes. "Reserves" are therefore the resources the charity has, or can make, available to spend, for all or any of the charity's purposes, once it has met its commitments and covered its planned expenditure.</p>
<p>Restricted Funds</p>	<p>"Restricted Funds" are funds subject to a specific trust which may be set up by the donor(s), or with their authority (e.g. in a public appeal), but still within the objects of the charity. Restricted funds may be Restricted Income Funds, which are expendable at the discretion of the trustees in furtherance of some particular aspect(s) of the objects of the charity, or they may be Restricted Capital Funds where the assets are required to be invested or retained for actual use, rather than expended.</p> <p>Some charities have power to declare specific trusts over restricted funds. If such power is available and is exercised, the assets affected will form a restricted fund, and the trustees' discretion to apply the fund will be legally restricted.</p>
<p>Unrestricted Funds</p>	<p>"Unrestricted Funds" are spent or applied in the discretion of the trustees to further any of the charity's purposes. Unrestricted funds can be used to supplement expenditure made from restricted funds. For example, a restricted grant may have provided part of the funding needed for a specific project. In this case unrestricted funds may be used to meet any funding shortfall for that period.</p>

Please note that these definitions are based on Charity Commission Operational Guidance.

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