Matching Program Strategy and PRI Cost

by Frances Brody, John Weiser and Scott Miller. Phyllis Joffe, editor.

Many foundation staff and board members view program-related investments (PRIs) as a complex and costly alternative to grant making. Yet regardless of whether a foundation pursues its program goals using grants, PRIs or a combination of both, overall costs are likely to be affected more by program strategy than by the tools used to implement that strategy.

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Just as grant making may be adventurous or conservative, so PRIs may support either untried or relatively well-documented approaches. Both the funder and recipient stand to benefit if the financing structure—whether grant, loan or equity investment—is appropriate for the project at hand.

For foundations that find it in their program interests to encourage the creation of new institutions and strategies, the costs of negotiating, documenting and monitoring both grant and PRI agreements are likely to be higher than for foundations supporting established programs. Such costs are a function of the uncertainty involved in innovation and reflect the importance of making expectations of both the funder and the grantee/borrower as explicit as possible. This inevitably means more staff time and often more paperwork for both parties.

When controls are well conceived and arise from a common understanding of the risks involved, they can help reduce the uncertainty of innovation not only for funders, but also for borrowers, who often acknowledge that the resulting discipline and focus are helpful.

The PRI strategies of two large foundations—Ford and MacArthur—at the end of the 1980s illustrate some of the effects of emphasizing different degrees of experimentation and innovation.[1] Both foundations helped to pioneer the use of PRIs. At the end of 1989, Ford's portfolio was $92 million, and MacArthur's, $32 million. At that time, MacArthur was distributing approximately twice the grant dollars per program officer and nearly three times the PRI dollars per PRI officer as Ford.

The reason for MacArthur's greater efficiency was that Ford's strategy—both for PRIs and grants—focused on innovation and experimentation with new models, while MacArthur was more oriented toward sup-

porting organizations and individuals with proven track records and established approaches. Similarly, while MacArthur had not written off any PRI investments at the end of 1989 and maintained no loss reserve, Ford's loss rate was 9.2% of its cumulative PRI investment dollars. Ford maintained a loss reserve of 15 percent of its outstanding portfolio to address the relatively high-risk profile of its strategy.

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Differences may be less dramatic among smaller PRI funders, yet such funders also represent a range of program strategies and associated costs. For example, a few small foundations began their PRI activities with direct loans to businesses or fragile housing developers, with the result that some PRIs had to be converted to grants. In contrast, those small foundations investing in experienced intermediaries and well-established users or developers (who are often previous grantees) generally have experienced modest costs and few, if any, losses.

Two Types of Risk

Innovation usually implies an increase in two types of PRI risks or uncertainties: program risk—the risk that program goals won't be accomplished; and financial risk—the risk that the investment (together with any interest due) won't be repaid. The first, program risk, is familiar to every grant maker. Any form of support for new organizations or untried approaches is "risky" in the sense that the potential program impact is often difficult to predict. Clearly, one reason is that a provision for considerable learning and refining often must be incorporated into innovative projects. Another is that innovation brings with it less certainty that the goals and expectations of the funder and recipient are closely aligned. In either situation, foundation staff members naturally feel compelled to be more thorough in investigating, stipulating terms for and monitoring both grants and PRIs supporting higher risk strategies.

The second broad form of PRI risk, financial risk, is often less familiar, to both grant makers and grantees, than program risk. Yet the fundamental elements are similar and, again, reflect concerns about the borrower's capacity to handle unfamiliar challenges and the alignment of financial goals and expectations. Because financial risk pertains to foundations, who seek to be repaid, as well as to borrowers, who accept responsibility for repayment, it is in the interests of both to clarify expectations and agree on controls that are effective and appropriate. Managing significant program or financial risk inevitably adds to program costs for both the funder and recipient, and these must be balanced against the potential for greater program impact.

Ways to Manage PRI Risks

Programmatically, the tools used to manage risk and ensure impact for PRIs are similar to those for grants. They include careful proposal review, discussions with the prospective grantees and agreements regarding the use of foundation funding. Both the grant letter and PRI contract generally state expectations about how funds will be employed and, often, about how the impact will be judged.

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Financially, PRIs involve additional efforts to ensure that the investment will be repaid. This generally includes an investigation into the financial and organizational stability of the recipient ("due diligence"); drafting of a legal agreement specifying certain levels of financial performance that the recipient must maintain during the term of the investment ("structuring"); and finally, a mechanism to track the extent to which the performance levels are, in fact, achieved ("monitoring"). In the case of new organizations and innovative approaches, reducing uncertainty through due diligence, structuring and monitoring activities may be costly for both the funder and borrower. However, for investments in more established programs, these steps may not add substantially to what the funder or borrower costs would have been for a grant of similar size.

In addition to due diligence, structuring and monitoring, another way to reduce uncertainty and the costs associated with it is to invest in established intermediaries. Such organizations not only command considerable experience in their fields, but also offer the further security of representing a pool of investments whose overall performance is more predictable than that of any one venture. When a PRI program is new or when the number of PRIs in a foundation portfolio is too small to balance risky investments with more secure ones, investing in experienced intermediaries enables a foundation's staff to be relatively confident of both the program impact and financial security. Because intermediaries are typically specialists with their own technical assistance staffs, investments through intermediaries also tend to reduce the staff time spent addressing potential problems after the investment has been made. Established intermediaries seeking funding for proven approaches may argue successfully that their existing program and financial controls are adequate and do not need to be redesigned for the loan agreement.

When no established avenues for achieving their program goals can be found, some foundations have pursued intentionally risky direct investment strategies even for their initial PRIs. Direct business or social venture investing is especially challenging, even for experienced program officers, yet it does provide a way of learning in depth about a particular field when less risky options are not available. For foundations that, for program reasons, prefer direct investment over support for intermedi-

aries, risk still may be minimized by working through well-established organizations using proven operating models. If either experience or a proven model are lacking, the overall risk is much higher. The absence of both is certainly a warning signal. Nevertheless, in those circumstances in which innovation or field development is central to the funder's mission, there are ways to craft an appropriate PRI approach. These approaches involve the choice between up-front costs to increase planning, underwriting, structuring and monitoring on the one hand, or acceptance of potentially higher losses on the other.

Adapting a Grant Strategy to PRIs

Just as with grant programs, a formal strategy for making PRIs might include stated program goals, size-range of potential investments, characteristics that the borrower must exhibit and many other factors. Whether a formal PRI strategy is called for depends on a number of considerations, not the least of which is whether the foundation anticipates making PRIs on a regular basis. Nevertheless, a few guidelines are helpful even in the case of a single PRI experiment.

How much experimentation (and therefore risk of failure) is implicit in the foundation's program goals?

In order to establish a reasonable and appropriate set of structuring and monitoring procedures for a proposed PRI, the program officer must be able to answer a number of general questions about how the PRI fits within the context of the foundation's grant-making and PRI strategy. These questions are not dissimilar from what one might ask about any grant proposal. From the borrower's perspective, these are questions that should be considered to determine the level of shared interests with the funder and the types of concerns that are likely to arise.

First, how much experimentation (and therefore risk of failure) is implicit in the foundation's program goals? As noted above, more experimentation implies higher cost, either in due diligence, structuring and monitoring; in loss rates; or both. The higher costs should be acknowledged as an integral part of the foundation's strategy. When there is a portfolio of investments, foundations often try to strike a balance of higher- and lower-risk investments that is commensurate with their program goals.

Second, how central to the interests of the foundation are the program goals of the proposed PRI, and what dollar amount is the foundation willing to invest to pursue them? This is a fundamental cost-benefit relationship that should be addressed, whether the investment is structured as a grant or as a PRI. For the borrower, the match between proposal and foundation goals is often critical, as foundations often consider making PRIs first to existing grantees and then to other organiza-

tions pursuing programs central to the foundations' interests.

Third, how much money is involved, relative to typical grant size and to the overall PRI budget (if there is one)? One of the motivations for making PRIs is often the desire to exceed typical grant sizes in cases with large potential program benefits. The expectation of repayment may justify substantially larger investments for PRIs, as compared with grants. However, larger investments generally warrant more careful structuring and monitoring.

Finally, to what extent should the foundation spend money now—in structuring and monitoring—in order to reduce the risk of losing money and/or program impact later? Although appropriate structuring and monitoring are determined in part by the degree of risk and the size of the investment, they also are a function of the tradeoff between current and potential future expenses. How much "insurance," in the form of legal structuring, should the foundation pay for now in order to reduce the potential for greater costs—in loan losses—one, three, five or more years from now?

Using the PRI Strategy to Arrive at Appropriate Costs

The answers to the questions above are a useful starting point for judging acceptable levels of PRI cost for a particular project. As a foundation's PRI experience grows and payback histories are documented, it becomes easier to predict the expected loss represented by any one investment.[2] Using the foundation's program strategy as a guide, both the program officer and borrower can begin to develop reasonable structuring and monitoring cost guidelines for the PRI. Similarly, the more experienced the borrower, the more likely it is to understand the risk inherent in its own program approach.

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What if a foundation does not have enough experience to accurately judge the risk of a PRI or enough volume to diversify risk over a number of investments? One answer is to keep things simple. For example, in order to control structuring and monitoring costs for its occasional PRIs, the Wallace Alexander Gerbode Foundation worked with outside counsel to create a "master agreement" that it uses as the basis for all its PRI contracts. The agreement is simpler than the type used by many large foundations and is not meant to cover every possible contingency.

Gerbode also minimizes both contracting and monitoring costs by structuring many PRIs, especially those involving significant repayment risks, as recoverable grants. The Foundation then uses a simple grant or loan commitment letter, including a provision that, if revenues are pro-

duced as projected, the grant will be repaid. Another advantage to recoverable grants is that they need not be treated as PRIs under IRS regulations, saving some additional reporting. If the grant is repaid, the repayment is reported and the capital must be redistributed at that time as a new grant or loan. In place of more complex legal provisions, recoverable grants and other PRIs with minimal contract and monitoring structures rest primarily on the relationship between a foundation and a recipient.

The negotiation about whether to use a recoverable grant or simple loan agreement centers in part on which party—the lender or the borrower—is more prepared to bear the financial risk that the venture may not produce the anticipated revenues. Whether the legal contract is one page or 500, clarity about who bears what risks is critical to maintaining a good relationship in the future.

Conclusion

Like many other financing arrangements, PRIs can be and have been made and repaid with little more legal foundation than a firm sense of mutual trust and understanding. The measures employed by a foundation to provide legal protection for PRI investments in the event of future problems are not inherently costly or difficult but should reflect the foundation's program strategy and the risks of each individual PRI. Just as with grant making, effective PRI investing involves understanding the trade-offs between cost and risk. PRIs may be high risk and costly or low risk and economical. To a significant extent, foundations choose the range of costs they will incur with PRIs when they choose their program strategies. A basic responsibility for foundation staff, whether using a grant or a PRI, is to seek a program impact that is appropriate to the total dollars spent, that is, investment plus costs less (in the case of a PRI) any expected repayment and interest.

Just as with grant making, effective PRI investing involves understanding the trade-offs between cost and risk.

For their parts, prospective PRI borrowers must be prepared to meet not just the program expectations, but also the financial risk profile of the PRI funder. Generally, it is in the best interests of the borrower to negotiate PRI terms from the standpoint of not just minimizing costs, but also identifying and controlling the true sources of risk that exist within the project or venture. Only when the program strategy of the foundation is consonant with the riskiness of the project are PRI costs and outcomes most likely to meet everyone's expectations.

Notes

1 The differences between PRI program risk strategies and risk profiles at the Ford and MacArthur foundations have grown less distinct in the years since 1990. After 1990, MacArthur institutionalized a dual PRI strategy. It maintained two PRI portfolios. One — part of its annual 5 percent distribution — made riskier PRIs, such as direct investments in businesses and occasional projects in developing countries. The second MacArthur PRI portfolio routinely exceeded the 5% distribution requirement and consisted primarily of investments in established intermediaries. Under new leadership in 2001, MacArthur's PRI strategy changed again, in line with changes in its overall program strategy. PRIs now support program initiatives and are managed as a portfolio together with market-rate mission-related investments.

2 Expected loss is equal to the probability of incurring a loss, multiplied by the amount of the loss.

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The comprehensive volume includes sections on the current perspectives of PRI providers and recipients; crucial tips on how organizations have successfully sought out and managed PRIs; a directory of leading PRI providers; examples of more than 550 PRIs; and much more. Program Related Investments: A Guide to Funders and Trends provides the information needed to understand the uses of charitable investing.

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