Endowments: Long-Term Funding for Nonprofits

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When should a nonprofit establish – and maintain – an endowment? The term "endowment" typically refers to funds set aside, either internally within a nonprofit or externally through a separately-created entity for the charity's benefit. Whether internally maintained or separately developed, endowments provide significant opportunities for financial stability, donor development, and risk management. But there are some drawbacks to this strategy, and nonprofit leaders should pay attention to these fundamental considerations.

What Does an Endowment Look Like?

A nonprofit may set up a special fund after receiving a large gift from a key donor (or donors). The donor may make certain restrictions, such as to engage in only certain charitable activities or to provide scholarships for certain educational pursuits. The nonprofit typically must invest the principal gift and promise to spend only income generated from the principal. The nonprofit organization must honor such restrictions through development of an investment policy, continued monitoring, and financial reporting. A nonprofit organization should avoid donor-imposed conditions that would cause the organization to move beyond its mission (absent intentional organizational changes).

Alternatively, donors may impose minimal or no restrictions. In that case, the nonprofit directors must determine how best to steward this valuable resource for the organization's long-term well-being. The directors may decide among themselves to restrict the endowment funds, such as to use them only for a building campaign or for other specific goals. Little or no reporting requirements or restrictions will apply, which is helpful for optimal flexibility.

Under either approach, the nonprofit organization may operate its endowment internally, as a separately accounted investment fund – perhaps in a separate bank account, or perhaps not. Alternatively, the nonprofit may set up a separate charitable organization to hold and manage the funds, to help demonstrate that the endowment fund is distinct and designated for the organization's long-term needs. Such approach provides better risk management protection, particularly if the organization is later sued and/or its assets become subject to claims of creditors.

Case in Point

Consider Helping Hands Nonprofit, an organization that has developed substantial support for overseas orphanage and jobs training programs, along with its other domestic charitable activities to care for those in need. Some supporters are excited about the overseas activities, but some are not. The directors of Helping Hands Nonprofit are facing financial challenges: its domestic, ongoing operational needs are compelling, but so are the overseas programs that require significant infrastructure development. Helping Hands Nonprofit's leaders are proud to have served over 1,000 families last year through its domestic programs. They also believe that many supporters in the community may be willing to increase their giving substantially for the overseas programs, with the right encouragement.

Should Helping Hands Nonprofit establish an endowment? If so, should it be internally or externally established? And should the organization's leaders impose any restrictions or be willing to accept any donors' restrictions, such as to use funds only for building an orphanage and not for job training?

If Helping Hands Nonprofit is receiving some large gifts here and there, it probably would be best if such gifts were without restriction – flexible enough to be used as the leadership deems best, and without ongoing reporting issues. But if the pipeline for such gifts seems fairly substantial, then a separately incorporated "endowment" nonprofit may be quite appropriate. Restrictions may be acceptable, provided that they can be maintained and followed consistent with the organization's mission. The risk management aspect is also quite important – to separate the high-risk program activities from reserve funding for long-term sustainability.

Keep in mind that a separately incorporated organization comes with additional responsibilities, such as forming the organization itself, developing a new board of directors, applying for IRS recognition of tax-exempt status, and handling future nonprofit governance matters. On the other hand, separately developing a new nonprofit (e.g., "The Helping Hands Foundation") may be just the ticket to inspire donors to give larger gifts.

These are all key considerations, with no "one-size-fits-all" answer. Additional legal and practical considerations also apply, as follows.

Are Endowments Beneficial?

Many nonprofit leaders face tremendous pressure to meet payroll, cover program expenses, and otherwise stay within their budgets. These ongoing issues often completely occupy their attention, with little to no bandwidth to pursue endowment funding. But to the extent an endowment enters the horizon (e.g., through a major bequest), the opportunity allows them to move beyond a short-term focus into long-term planning for financial sustainability.

One key benefit is that an endowment helps diversify an organization's income and reduces its dependency on annual campaigns, special events, and traditional fundraising, which can be unpredictable sources of income. An endowment thus can help to "smooth out" the overall income stream. In addition, an endowment can be enormously comforting for donors. Having a capital base reassures donors that the organization will be around for awhile. An endowment offers donors an alternative that keeps giving well into the future, unlike gifts that meet a nonprofit organization's one-time needs.

The flip side, however, is that endowments are not good for all organizations, and not everyone loves them. Campaigns to fund endowments can divert much-needed attention from an organization's current needs, begging the following question: Should we forego our immediate needs to save for an unknown future? If it is a matter of survival, the answer is obvious. A bad economy can persuade nonprofits that they need to bolster their endowments so they will always have a financial cushion for tough times. But for some donors that argument is a tough sell because they want to fund current needs rather than contribute to a "war chest."

Donors also may not feel so compelled to give if they see that the organization is already financially well-endowed.[1] Developing an endowment thus provides significant impetus for improving a nonprofit's fundraising strategy overall, particularly to ensure that donors understand why giving generously to *current* programs is still compelling – and critically needed.

A Board's Fiduciary Duties for Endowment Funds

Nonprofit directors owe fiduciary responsibilities to handle endowment funds with diligence and loyalty to the organization. These legal duties do not require that directors be financial experts. Rather, directors serve an oversight function as "bumper guards" to ensure that sufficient financial expertise is utilized for prudent investment fund management, often through outsourcing to investment advisers. Directors must require and carefully evaluate periodic financial reports, using an attitude of constructive skepticism to protect the organization's well-being.

The Uniform Prudent Management of Institutional Funds Act (UPMIFA) has been adopted in many jurisdictions to govern nonprofits' investments, with a modern standard of prudence and flexibility. To comply with UPMIFA's standards, a nonprofit's board should take several steps, as follows.

First, develop a spending policy that details the extent to which endowment funds may be disbursed. The policy must be consistent with any applicable donor-imposed or self-limiting restrictions. For example, if an endowment's donor requires that no more than the endowment's annual investment income is to be spent, then the directors must vigilantly guard against spending of the endowment's principal funds. With respect to a charity's self-imposed restrictions, the organization's leaders certainly may change course – but only after affirmatively modifying internal policies. Absent such restrictions, a commonly used method is to calculate the annual withdrawal amount using between 4% and 5% of the portfolio's value.

Second, develop an investment policy for the endowment funds that contains the following elements: identification of a investment fund manager (or standards for selecting the manager); the organization's risk and return objectives (typically quite conservative, in keeping with the directors' fiduciary responsibilities to guard charitable assets); how these objectives relate to the organization's spending policies; and the strategies employed for achieving those objectives.

Third, provide for appropriate disclosures through financial reporting, including identification of specific endowment funds along with any applicable donor restrictions and annual financial reconciliations.

Additional Considerations

Establishing an endowment is not an essential goal for every nonprofit, nor will it be achieved overnight.   However, just like any savings program, starting early works best; even in less than ideal economic situations, the groundwork can be laid for building an endowment.

In evaluating whether to establish an endowment, a nonprofit organization's board may find the following legal and practical considerations useful:

1. What other like-minded organizations have an endowment?   How does the endowment further their nonprofit mission?
2. How does an organization differentiate fundraising for operating needs versus endowment?   How do such efforts fit with overall strategic planning?
3. Should gifts from major donors and institutional grants go towards an endowment?
4. Would an endowment significantly help a major gifts' campaign, or otherwise open new doors?
5. What are the legal risks of having restricted endowment assets?
6. Can strong governance practices be developed, to ensure prudent investment decisions are made and capably overseen by the board?
7. Should an endowment be separately incorporated and operated?

[1]   Donor reluctance does not seem to be problematic for Harvard, Yale, and other elite educational institutions, where their endowments are reportedly $1.3 to $2.6 million *per student*.   But such nonprofits are facing increasing pressure from within the nonprofit sector and Congress, particularly in light of high tuition fees, to spend more of their endowments on current programs (such as private foundations must do).

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