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## A MANAGEMENT APPROACH TO ALLOCATING MAJOR GRANTS Capacity Based Grant Administration for Foundations and Endowments

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### Large Restricted Grant Administration

A donor commitment to fund a large restricted account is often celebrated as a great moment by a charitable organization. There is much to gain and much to lose for the charity, which will face a daunting task in managing a large restricted fund. It has the opportunity to achieve significant program goals. Effective implementation of the grant process may also enhance the ability of the charity to attract substantial new funding sources.

Administration of a large restricted account can be a hazardous enterprise, as it is easy to fall into administrative traps. These pitfalls can frustrate the donor and injure the credibility of the receiving charitable organization. This article outlines classic administrative problems that may develop in large grant execution, and proposes a unique administrative solution for preventing and repairing these situations called "capacity based grant administration".

A well-structured grant administration process can help the charity's Executive Director with many decisions and prevent some of the worst potential organizational problems. Major donor grants to a charitable organization are referred to as targeted or restricted, and are designated for a specific purpose. The charitable organization selected to receive the large restricted grant either has the capability to directly achieve the intended result, or it serves as a conduit for dispensation of funds.

Serving as a grant conduit, the charitable organization receiving the major restricted grant, referred to as a Conduit Charity, has responsibility for locating, screening and contracting with many other, normally smaller, organizations to fulfill the mandate of the major restricted grant.

The key to understanding the reason for the conduit relationship is that the Donor normally cannot otherwise achieve the objective. If it was easy to do, the Donor would simply transfer funds directly to ready and waiting Project Recipient Organizations. Conduit Charities are only used when capacity is lacking and it is difficult to identify, contract and supervise the intended projects. There is no free lunch for the Conduit Charity. From the beginning, the Conduit Charity is faced with a task that others cannot accomplish.

The four parties in the transaction are defined in the following discussion for purposes of ease in comprehension: The terms for each party will be used throughout this paper, and the accompanying graphic diagrams are color coded to represent each of the four groups.

1. The Donor (individual, Governmental Organization or Non-Governmental Organization) that determines the target, or purpose for the major grant. The restricted fund is either granted in full, or as is most common, a multi-year pledge is made from the Donor.
2. The Conduit Charity is a charity which is selected to locate, screen and implement the distribution of funds for charitable purposes.
3. The funds from the Donor are held in and distributed from the Restricted Fund. Technically the Restricted Fund is a subset of the assets of the Conduit Charity, and the ongoing non-profit status of the Conduit Charity is contingent on the Conduit Charity making grants in compliance with non-profit law and IRS regulation.
4. The Project Recipient Organizations (PROs) receives distributions and implements programs. These programs combine to form the "portfolio" of projects selected by the Conduit Charity to fulfill the mandate of the Donor.

#### Benefits of Managing a Successful Restricted Fund

A successful restricted fund can provide many benefits for the receiving charitable organization. It can achieve the following:

1. Provide funding for high-value directed projects that fit the mission of the Conduit Charity.
2. Attract matching contributions from other NGO, government or individual donor sources with which to co-fund projects. This can leverage the impact of the Restricted Fund.
3. Increase the confidence of the restricted fund Donor, enhancing the potential for the Donor to commit substantial additional funding.
4. Raise confidence in the major Donor, who may consider committing additional funding to other areas managed by the charitable organization based upon satisfaction with its administration of the Restricted Fund.
5. Enhance visibility of the Conduit Charity, attracting funding from additional sources.

The Donor will normally clarify at the time of grant if the money in the Restricted Fund is to be spent down (perhaps \$10 million per year for 5 years), or is in the form of a perpetual endowment. (e.g. 5% interest annually on a one-time gift of \$50 million.) Many times large Donors will make a restricted grant that is a "toe in the water"; they may place \$50 million with the Conduit Charity in a Restricted Fund to observe performance, with the opportunity for more to come if performance is good.

In the typical format the purpose for the Restricted Fund is defined by the Donor, but the Conduit Charity has wide latitude in granting within the designated purpose of the account.

#### The First Problem: Delayed Project Execution

It may be easy for a Conduit Charity such as a college foundation to administer the award of college scholarships, but many large restricted gifts involve more complex project-related funding.

For a substantial new Restricted Fund, it is rare to have enough Project Recipient Organizations that have adequate capacity to absorb available grants. This makes sense on reflection, as small PROs with excellent capacity to execute a project don't usually last long without funding.

There are usually a few Project Recipient Organizations with projects in the ready stage that can be fulfilled by grants from the Restricted Fund in short order. Other potential projects are found in process, where the PRO is still developing the capacity to execute the project but the project is not mature enough to fund.

A still larger group of potential projects is usually identified that are more difficult. In these cases projects may be great ideas but are in the drawing-board phase and the PRO itself does not yet have internal capacity to execute. *When there is no current capacity to execute, it is only prudent for the Conduit Charity to withhold funding to the Project Recipient Organization until capacity exists to execute the project.*

#### The Second Problem: The Tendency for the Conduit Charity to Fully Commit

The Conduit Charity often makes contingent pledges from the Restricted Fund to PROs developing suitable projects. A large Restricted Fund run by a Conduit Charity with a multi-year donor commitment will build a portfolio of suitable projects. Some can be funded in short order, and others are identified for funding in coming years when the capacity of the PRO is adequate to execute the project.

The tendency to fully commit the Restricted Fund comes naturally. The Conduit Charity has a need to report projects executed and in pipeline to the Donor. This is especially true if there is a "toe in the water" situation where there may be much more to come from the Donor. The portfolio of projects can often be looked at as a bucket. The goal for the Conduit Charity is to fill up the bucket with well screened, suitable projects and report success to the Donor.

An unintended problem occurs when the bucket is full. The major Donor wants to see funding and execution of projects with their money, a reasonable expectation. However, responsible stewardship of the money requires that distributions are only made when benchmarks are met, so it is also reasonable that funds are withheld until benchmarks are achieved.

When the funding bucket is full of committed projects, it is often very difficult for the Conduit Charity to responsibly get the money out the door in the timeline expected by the Donor. The Restricted Fund is now committed, but funding of projects is too slow. Without a management system, it is easy for the Donor to become frustrated. The Conduit Charity may appear incompetent when they are instead acting in the best interest of the Donor and the purpose of the Restricted Fund.

An example follows and is shown in Diagram 1: In this case, commitments have been made for the full Restricted Fund. The amount is \$50 million, expected to be distributed at \$10 million per year. In year one, the ready projects candidates are identified and funds are released at the end of the year.

In year two in the example, a little more of the money is released, but the balance cannot be released until project benchmarks are met. This leads to distribution problems. *Nothing can be released due to capacity problems and no new funding commitments can be made, as the fund is fully committed.*

As Diagram 1 illustrates, the impact of delayed granting becomes more pronounced in later years. At the end of the period when \$50 million was expected to be released, \$24.5 million has yet to be distributed. This type of delay and significant deviation from plan can be avoided through a capacity-based funding system.

#### Proposed Solution: Multi-Stage Capacity-Based Grant Administration

The process can provide needed flexibility to the Conduit Charity in grant administration for the Restricted Fund. Combined, the five-steps of the process can help to avoid the problems outlined above and can provide needed structure in prioritizing the award of grants.

1. Once projects are identified, all PROs, sign a “letter of intent” indicating that they understand the project has a provisional commitment. It must meet stated benchmarks to receive funding.
2. The projects are separated into funding rounds, called tranches. This is done by order of capacity of the PRO and priority of project merit as assigned by the Conduit Charity. In Diagram 2 five tranches are shown.
3. The letter of intent provides that the PRO’s project is targeted for a certain tranche, but will be moved back to a later funding tranche if they do not meet capacity milestones on time.
4. PROs are informed that if their project does not meet milestones and does not qualify for Tranche 5, they will be moved into the next donor grant cycle, if one is forthcoming. This implies the risk that if the PRO does not develop project capacity on schedule, they will be moved back and will have the risk of forfeiting funding if they cannot qualify for Tranche 5.
5. Replacement projects are identified constantly, as there is a fluid process of moving not-ready projects to a later tranche and ready projects up to an earlier tranche.

Diagram 2 shows the intended result of this approach of Capacity-Based Grant Administration.

#### Repairing Restricted Funds that are Bottlenecked by Full Subscription

A repair process can be implemented by the Conduit Charity by initiating new “letters of intent” with every PRO for which a grant is committed. This should be done after conferring with the Donor to make sure that the Donor understands that the process is being changed, and that some of the projects previously identified will wash out.

The Conduit Charity can then implement all of the five steps outlined above. This includes identification of a new set of potential grant recipients that may fit into each of the pending tranches as projects lacking capacity are moved back to later tranches in the system.

#### Additional Donor Funding for the Restricted Fund

Between the time the first two and three years has passed is an ideal time to revisit the topic of additional funding by the Donor. The Donor by year three has seen two full tranches funded.

The Conduit Charity should also have good visibility on the progress of projects in the next three tranches. If the funding capacity of the initial Restricted Fund is fully pledged for all five tranches, there may already be projects that are being pushed back beyond Traunch 5 that may be attractive but unable to meet benchmarks in the required timetable.

This is an ideal time for the Conduit Charity to describe to the Donor the type of projects that are being pushed back beyond the Fifth Traunch of the fund and to appeal for additional funding. If there are highly attractive projects that fit the mandate of the Restricted Fund but are beyond the initial commitment of the Donor, funding these additional projects may be of interest to the Donor.

#### Choices for the Committed Donor

The Donor that is satisfied with the progress of the Conduit Charity that wants to place additional funding in the Restricted Fund has several choices.

##### A. Continuation Funding

The Donor may want to continue funding one year at a time. In this case, it is ideal to have the commitment of the Donor to fund a Traunch 6 by the beginning of year 3. With a four-year lead time, this will allow the Conduit Charity the ability to identify new, high impact Projects, and to guide PROs in meeting project benchmarks for funding. At the end of year 4, the Donor and Conduit Charity can then discuss the funding for Traunch 7.

##### B. Full Renewal Funding

The Donor can again commit an amount similar to the initial contribution. This may enable funding of another five Traunches of similar size, and allow the Conduit Charity to engage in an expanded Project development process. The Donor should consider increasing the commitment by an inflation adjusted amount if they want to achieve the same economic impact as the initial grant to the Restricted Fund.

##### C. Funding Larger Projects with Greater Impact

The Donor and Conduit Charity may have identified larger projects with greater impact. In this case, the discussion may be about conducting the same process, but with a larger financial commitment. In this case, the Donor must have the ability to fund at a higher level, and the Conduit Charity will need to examine whether it will need to enhance its internal capacity in order to supervise funding of larger and more complex projects.

The Donor may elect to provide additional contributions to the Restricted Fund as described. Typically this will occur if the following conditions are met:

1. The Donor has adequate funds to make an additional contribution.
2. Communication between the Donor and the Conduit Charity about project funding is harmonious.
3. The Donor believes that the Project Recipient Organizations selected by the Conduit Charity satisfy the Donor's funding mandate.
4. The Donor perceives that the Conduit Charity has made satisfactory progress in moving money from the Restricted Fund to the Project Recipient Organizations.

5. The Donor believes that adding to the Restricted Fund is more important than funding requests for other causes.
6. The Donor believes that new, potentially unfunded, projects are worthwhile.

### Summary and Conclusion

The Result of using Capacity-Based Grant Administration with multiple funding tranches should be measurable in the first year of implementation. The process described can also help to align expectations between the Donor and the Conduit Charity.

Communication between the Donor and the Conduit Charity can be focused not just on the merit of projects, but on the capacity of PROs to execute the projects. The process includes the use of benchmarks, with a clear standard of measurement for each PRO in executing projects funded by the Restricted Fund.

The use of benchmarks should help to impose realistic expectations upon PROs regarding the need for capacity development. Those PROs hoping to have their projects funded are responsible for meeting benchmarks. If they do not, their grant is moved back to a later tranche or, if it is moved to the back of the line, potentially not funded. Using the Capacity Based method helps assure that only the most ready and capably administered projects are funded in each funding round.

Implementing this capacity-based approach to granting from a Restricted Fund should lead to a more predictable process and should professionalize the relationship between parties. Each has to accomplish specific goals to meet objectives.

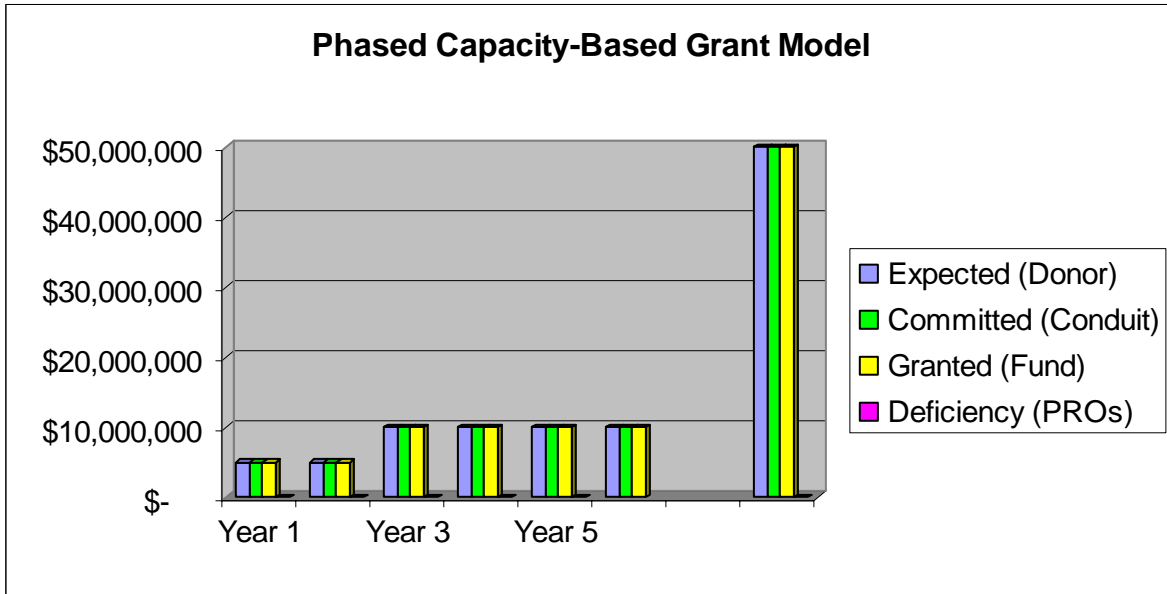
The result of utilizing this process should be improved ability for the Donor, the Conduit Charity and the Project Recipient Organizations to understand one another and to fully realize the funding of high priority projects. A Capacity-Based Grant Administration system can help to effectively meet recipient, charity and donor goals.

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**Diagram 2**



*For Illustrative Purposes Only*

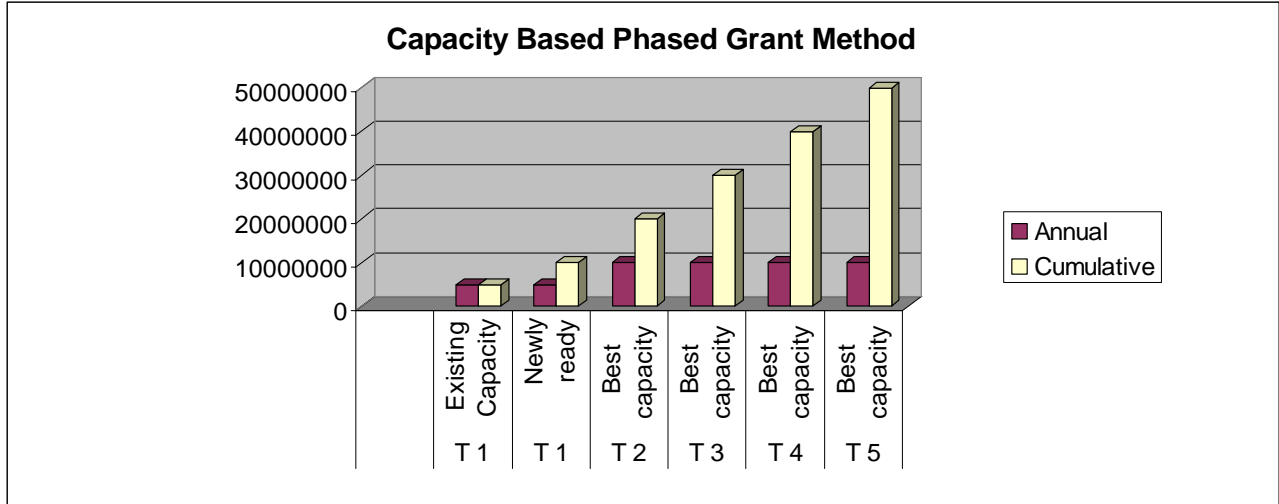
**DISTRIBUTION MODELS FOR MAJOR GRANTS**

**PHASED TRAUNCH MODEL**

Diagram 2

Schedule	Distributions expected by Donor	Grants Committed by Conduit NGO	Granted by Conduit NGO to PROs	Deficiency (Not yet paid to PROs)
Year 1	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ -
Year 2	\$ 5,000,000	\$ 5,000,000	\$ 5,000,000	\$ -
Year 3	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000	\$ -
Year 4	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000	\$ -
Year 5	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000	\$ -
Year 6	\$ 10,000,000	\$ 10,000,000	\$ 10,000,000	\$ -
<b>Totals:</b>	<b>\$ 50,000,000</b>	<b>\$ 50,000,000</b>	<b>\$ 50,000,000</b>	<b>\$ -</b>

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