CHARITY COMMISSION FOR ENGLAND AND WALES

Title: Charities (Total Return) Regulations 2013	**Post Implementation Review**
Original IA/RPC No: n/a	**Type of regulation:** **Domestic**
Lead department or agency: Charity Commission for England and Wales	**Type of review: Statutory (non-Parliamentary)**
Other departments or agencies: **n/a**	**Date measure came into force:** **01/01/2014**
Contact for review enquiries: strategyandinsight@charitycommission.gov.uk	**Recommendation: Keep**
	RPC Opinion: n/a (de-minimis)

1. What were the policy objectives of the measure?

The policy objectives of the 2013 Regulations were to: (a) facilitate the adoption of total return investment (**TRI**) by charities; (b) decrease the regulatory burden on both charities and the Commission, because charities no longer need the Commission's authority to adopt TRI; and (c) implement safeguards to ensure that permanent endowment is not misused or eroded, protecting charity assets and the rights of donors.

2. What evidence has informed the PIR?

- Internal casework review (identified no cases involving TRI since 2014).
- Feedback from external stakeholders – Association of Charitable Foundations, Charity Investors' Group, Charity Law Association, ICAEW and NCVO.
- Information passed on by the Law Commission and comments from an individual who contacted the Commission directly
- Review of correspondence and impact assessments from the original implementation.

3. To what extent have the policy objectives been achieved?

The policy objectives have been, and continue to be, achieved. There is a strong consensus amongst stakeholders that the 2013 Regulations effectively facilitate TRI by permanently endowed charities and should remain in force. The review indicates: (a) increased take-up of TRI amongst permanently endowed charities; (b) reduced regulatory burden; and (c) that the safeguards included in the 2013 Regulations are working effectively.

Sign-off for Post Implementation Review: Helen Stephenson CBE, Chief Executive Officer

I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.

Signed: Date: 20/12/2018

Further information sheet

Please provide additional evidence in subsequent sheets, as required.

4. What were the original assumptions? That the 2013 Regulations would: (a) encourage take-up of TRI and; (b) decrease the associated regulatory burden on both charities and the Commission. These assumptions have been borne out.
5. Were there any unintended consequences? None identified. Continuation of the policy and the statutory power is strongly supported by permanently endowed charities and their professional advisers.
6. Has the evidence identified any opportunities for reducing the burden on business? • The need for the statutory power to adopt TRI with appropriate safeguards remains. • It may be possible to clarify or simplify the terminology and language used in the 2013 Regulations and our supporting guidance on TRI, but given the small number of charities that would benefit, the ability of those charities to access professional advice and pressure on our resources, it would not be proportionate to prioritise substantially revising the 2013 Regulations or the TRI guidance at the present time. • Stakeholders have identified some minor technical issues in the 2013 Regulations that can be corrected by further amendment regulations which we will make.
7. For EU measures, how does the UK's implementation compare with that in other EU member states in terms of costs to business? Not applicable

Review of the Charities (Total Return) Regulations 2013

1. Introduction

This report sets out the results of the Commission's post implementation review of the Charities (Total Return) Regulations 2013 (the **2013 Regulations**). The 2013 Regulations enable charities with permanent endowment to adopt total return investment (**TRI**) without the Commission's authority.

The review was carried out pursuant to the requirements set out in regulation 9 of the 2013 Regulations. In conducting the review, the Commission has considered whether and to what extent the 2013 Regulations:

- have achieved their original objectives
- are still required and remain the best option for achieving those objectives
- could be achieved in another way which involves less onerous regulatory provision.

Section 2 describes the context and purpose of the 2013 Regulations. Section 3 summarises the review methodology. In sections 4 and 5 we discuss the results of the review, including the feedback we received from stakeholders. Our conclusions are set out in section 6.

2. Context and purpose of the 2013 Regulations

The Trusts (Capital and Income) Act 2013 (the **2013 Act**) inserted a new power into the Charities Act 2011 allowing trustees of permanently endowed charities to adopt TRI, without having to seek the Commission's authority. The 2013 Regulations complete the legal framework by setting out the rules that trustees must follow when exercising this power.

Permanent endowment (**PE**) is property of a charity (land, buildings, cash or investments) that the trustees cannot spend; they must hold it permanently, either to further the charity's purposes or to produce an income for the charity, depending on the terms on which it was given. PE has been used as a means of establishing and benefitting charities for centuries.

Where PE is invested to produce an income for the charity, the trustees must maintain a strict distinction between income receipts (which must be spent on the charity's purposes) and capital gains (which must be added to the charity's endowment). The trustees must invest in a way that maintains an appropriate balance between capital and income, to balance the interests of the charity's current and future beneficiaries. These rules can be problematic, for example, if investment income is low and capital gains are high, as the charity may be left with limited income to meet current beneficiary needs.

Charities that adopt a TRI approach don't have to make this distinction. Instead, their trustees can seek to maximise the charity's total investment return, no matter whether it takes the form of capital or income. Under the 2013 Regulations, all investment returns are designated as "unapplied total return". The trustees then decide how to allocate it between the "trust for investment" (which is treated as capital and added to the endowment) and the “trust for application” (which is treated as income to be spent on the charity’s purposes).

The 2013 Regulations contain safeguards to preserve the capital value of charities’ PE. Donors of PE should be confident that PE remains a valid and useful way of establishing or supporting a charity, and that the regulatory framework will support their intentions.

Before the 2013 Act, charities could only adopt TRI by applying for a Charity Commission Scheme or Order (unless the power to do this was included in their governing document). The 2013 Regulations are more efficient for charities and the Commission, removing the need for the Commission’s involvement in most cases.

For more information on TRI under the 2013 Regulations, see the Commission’s guidance on total return investment (the **TRI Guidance**).

3. Review process

The Commission has reviewed the original consultation and impact assessment documents. We have also looked for evidence in our records relating to charities and casework. We asked colleagues for details of any cases they had dealt with involving TRI by permanently endowed charities. We also asked external stakeholders for feedback on their experience of using the 2013 Regulations.

We received feedback from:

- the Association of Charitable Foundations (representing 350 UK foundations and grant-making charities)
- the Charity Investors’ Group
- the Charity Law Association (which consulted its members and reported their responses)
- the Institute of Chartered Accountants for England and Wales (ICAEW)
- the National Council for Voluntary Organisations (NCVO).

We also considered:

- feedback passed to us by the Law Commission following publication of their report, *Technical Issues in Charity Law* (September 2017)
- comments from a charity trustee and former solicitor, who contacted the Commission directly

We are very grateful for the feedback provided by these organisations and individuals.

4. Issues identified by research and stakeholder feedback

A number of key themes emerged from our review.

4.1. Usefulness of the 2013 Regulations and power to adopt TRI

The Commission has no record of the number of charities that have adopted TRI under the 2013 Regulations; trustees can resolve to do this without our authority. However, stakeholders all agreed that TRI is an essential power for those charities that use it, and one which they want to retain. Stakeholders also agreed that the 2013 Regulations have enabled a much broader take-up of TRI than under the previous regime. (The impact assessment for the 2013 Act identified only 46 charities that had adopted the power by Commission Scheme or Order).

Overall, stakeholders agreed that the 2013 Regulations are effective in providing charities with a workable framework that enables charities to invest more flexibly whilst preventing misuse or improper erosion of their PE. They commented that the power has:

- made it possible for trustees (and their investment managers) to maximise overall investment return for permanently endowed charities
- helped permanently endowed charities to budget and plan more effectively, allowing them to fund longer term initiatives
- enabled charities to take advantage of investment management services that are made available on a total return basis.

Available Commission records and reports from Commission case officers indicate that there have been no permissions cases since the 2013 Regulations came into force in 2014. This suggests that those charities wishing to adopt TRI have been able to do so successfully under the 2013 Regulations without involving the Commission. The Commission also has no records of any regulatory compliance or inquiry cases involving any misuse or abuse of the power to adopt TRI under the 2013 Regulations. This suggests that the safeguards included in the 2013 Regulations have been working effectively to date.

In practice, power to adopt TRI has proved most relevant to charities with larger holdings of PE to invest. Stakeholder feedback and our own records indicate that this is a relatively small group of charities. (In 2009, the Commission identified approximately 14,000 registered charities with PE; half of those had an income of £5,000 or less). The charities likely to adopt TRI under the 2013 Regulations are significant in financial terms, however. Three of the charities that contributed to stakeholder feedback have incomes between £1.4m and £53m. Stakeholder feedback suggests that the power to adopt TRI is less likely to be used by smaller permanently endowed charities.

As one stakeholder noted, the value of the power to adopt TRI under the 2013 Regulations “should not be measured solely by how common its use is.”

Stakeholders advise that other charities may be interested in adopting TRI but may find some of the following barriers off-putting.

4.2. Complexity

Some stakeholders found both the 2013 Regulations and the Commission's TRI Guidance concise, clear and helpful. Others found the terminology and parts of the process (particularly around valuing the original "trust for investment") unnecessarily complex. Complexity was also highlighted in the responses to the consultation on a draft version of the 2013 Regulations, and evidently could not be completely resolved. Stakeholders recognised that investment generally, and TRI in particular, are complex subjects.

Overall, we are not persuaded that revising the language in the 2013 Regulations and the supporting TRI Guidance would be the most efficient or effective use of the Commission's resources at this time. This is because:

- overall, stakeholder feedback on the 2013 Regulations and the TRI Guidance has been positive, indicating that they are working well in most cases
- as noted above, the power to adopt TRI under the 2013 Regulations is relevant to a comparatively small number of charities
- thanks to their size, these charities are likely to have access to professional advice to assist them in dealing with difficulties that may arise in practice.

4.3. Limits of scope/accounting issues/social investment

Some stakeholders reported that the accounting treatment that must be used where a charity adopts a TRI approach can cause difficulties for charities that have both permanent and expendable endowment, because different funds must be accounted for differently. The 2013 Regulations do not govern accounting treatment, so this issue falls outside the scope of our review. However, we will pass these comments to the Charities SORP Committee for their consideration.

One stakeholder commented that, if a charity has opted in to TRI under the 2013 Regulations, it is unclear if they can make social investments. Our guidance on social investment by charities explains that trustees can use PE to make social investments provided that this will not contravene the applicable restrictions on expenditure. For charities that have adopted TRI under the 2013 Regulations, this generally means that:

- the trust for application can be used to make social investments, including social investments that are expected to generate a negative financial return
- the unapplied total return and the trust for investment can be used to make social investments, with the exception of those that are expected to generate a negative financial return.

4.4. Risk of negative UTR and difficulty of exiting TRI

A number of comments suggest that TRI becomes more difficult and less attractive in falling financial markets. If a charity falls into "negative unapplied total return" (the current value of the overall investment falls below the initial valuation) it will have no investment income to spend. In these circumstances, a charity might want to exit TRI, but they may be unable to do so because they cannot recoup the loss in investment value as required. Strictly speaking, this is not a deficiency in the 2013 Regulations themselves, but an investment risk.

The 2013 Regulations do not allow a charity to 'cut its losses' in such circumstances, even if it would be in the best interests of a charity to do so. We do not consider that it would be appropriate to address this by way of a general power in the 2013 Regulations; rather, bespoke consideration and authority from the Commission would be needed. On that basis, there would be no benefit in amending the 2013 Regulations but we would of course consider providing an appropriate 'exit route' from TRI by Order if we were satisfied this was in the best interests of a charity.

4.5. Clarity about the purpose of the regulation 4 power

One stakeholder recommended that the 2013 Regulations should clearly state that the power to borrow up to 10% of the trust for investment in regulation 4 of the 2013 Regulations is not intended as an alternative to other powers to spend capital in the Charities Act 2011. This is already stated in the existing TRI Guidance.

The dual purpose of the regulation – to create greater flexibility whilst preserving the capital value of PE, is the root of much of the complexity on which stakeholders have commented.

5. Suggestions and recommendations from stakeholders

5.1. Technical issues with the 2013 Regulations

The Charity Law Association and other stakeholders highlighted particular provisions in the 2013 Regulations that may require clarification or correction. In particular they recommended that:

- the definition of "relevant percentage" in regulation 2 should be amended so that it is clear that the percentage should be calculated by reference to the most recently published version of the relevant inflation index
- the trustee duty in regulation 6(2) should be modified so that it is clear that what is expected is that the trustees *reasonably believe* that adopting TRI under the 2013 Regulations will not prejudice the ability of the charity to further its purposes now and in the future. This change is needed as trustees can only act on what they could reasonably be expected to know and consider at the time of their decision.

In the circumstances we agree that clarification of the 2013 Regulations is needed and will make an amending regulation accordingly.

5.2. Ability to split the PE fund

One stakeholder suggested that the 2013 Regulations should permit a charity to split a PE fund and manage part on a TRI basis and part according to the standard rules on investing PE. No other stakeholders suggested that this would be useful; several highlighted accounting difficulties which arise where there is more than one fund or asset (such as a combination of PE and expendable endowment – as noted under accounting issues). We therefore do not consider it would be advisable to make such a change to the 2013 Regulations.

5.3. Change to the borrowing limit

Some stakeholders suggested that the 10% limit on the power to borrow from the trust for investment (regulation 4) should be increased. Having considered the arguments for this proposal we would not support it on the basis that: (i) it would expose the fund to greater risk; (ii) other powers to spend capital are already available within the Charities Act 2011; (iii) the Commission can authorise trustees to borrow more than 10% of their charity's PE if we are satisfied it is in the charity's best interests.

We note that the Law Commission's *Technical Issues in Charity Law* report recommends that trustees are given a new statutory power to borrow from their charity's PE by allowing them to resolve to spend up to 25% of the value of the PE subject to requirement that they recoup that expenditure within 20 years. If implemented, this power would overlap with the power in regulation 4 of the 2013 Regulations, but it would have a wider range of potential uses. We are currently awaiting the Government's response to the Law Commission's recommendations.

5.4. Removal of the inflation-based cap

One stakeholder suggested that the inflation-based cap on allocating unapplied total return to the trust for investment should be removed from the 2013 Regulations. This suggestion was also considered by the Law Commission in their *Technical Issues in Charity Law* report. The Law Commission commented that: "This suggestion raises questions about appropriate accumulation of income and concerns about tying up capital. We do not think that it is a pressing concern since the unapplied total return is treated in the same way as the trust for investment until it is allocated to the trust for application." We agree with the Law Commission's comments and do not therefore propose to take this suggestion forward.

6. Conclusions and recommendations

There is a strong consensus that the 2013 Regulations remain useful and provide an important enabling power for large permanently endowed charities, and should remain in force. Given the need to balance greater investment flexibility with protection of PE, there would not appear to be any better way of providing this power than within the current framework. We have therefore concluded that the 2013 Regulations should remain in force.

The issues of complexity of language and terminology used in the 2013 Regulations was highlighted in the original consultation on the draft regulations. Bearing in mind the objectives of the 2013 Regulations, we can see no straightforward way of simplifying their language or improving the processes created by them without completely reworking them, which would not be a proportionate response in the circumstances, given that most stakeholders consider they are operating effectively.

In view of resourcing constraints, other priorities in the wider context of our strategic review, the very small number of charities that would benefit and their capacity to obtain their own advice, it would also not be proportionate for the Commission to review the TRI Guidance.

Some stakeholders highlighted a few exceptional cases that do not fit well within the 2013 Regulations. Given the small number of instances where these are likely to arise, and the absence of any actual cases coming to the Commission, the most proportionate response would be to deal with such cases by Order if and when they arise. It would not be practicable to cover all possible circumstances in the 2013 Regulations.

Stakeholders have, however, identified two specific issues with the wording of the regulations as set out in the body of this report. We agree these should be corrected and will make an amending regulation accordingly.

Stakeholders also identified one issue relating to accounting for TRI, as described above. We will refer this to the Charities SORP Committee for consideration.