Charity borrowing

Why do charities borrow money and why is it important?

As grants and donations get harder to access, many charities are looking at new trading activities to generate additional income for its core social work.

Charities are limited in how much trading they can do by the Charities Commission. Many charities set up a trading arm, also known as a subsidiary company. This trading arm is in effect a social enterprise wholly owned by the charity. This means all the profits generated by the trading company are donated to the charity. Examples include charity shops set up by charitable organisations such as Cancer Research UK and Oxfam.

A charity looking to set up a trading arm will need money to kick start the new business idea – which could be, for example, opening a charity shop or providing training and advice services commercially. The charity will need money for premises, equipment, marketing, staff etc. The charity may already have the money itself which it may choose to invest in the new trading company or lend it the money it needs. If, on the other hand, the charity does not have sufficient cash to do this, it may look at borrowing the money from a lender.

However, many lenders are unwilling to lend to a subsidiary that has not yet started trading because it is seen as a high risk business start up. The fact that the profits are meant to be redistributed to the charity can also be a concern to the lender as their priority is to ensure that the company can repay the loan.

One option is for the charity to borrow the money and lend it onwards to the trading subsidiary. Alternatively, the charity could be the guarantor for a loan that the subsidiary receives directly. In either case, the charity will in effect be borrowing the money itself.

Whether you are a charity with a trading arm or a social enterprise that is a registered charity, you need to be aware of how to borrow as a charity, and the implications of doing so.

How does it work?

There are a number of ways in which taking out a loan can be helpful for charities and their funding strategies:

- To purchase fixed assets such as a building or a van (not always supported by grant funders)
- To fill a bridging period until grants or payments for new contracts are received
- For working capital, i.e. for day to day activities
- To enable new income generating activities, such as purchasing stock for re-sale
- To finance fundraising plans, i.e. borrow money to launch a campaign to raise funds from donors/ funders
- Purchasing property (buying, renovating or building property), by far the most common reason to borrow.

Charities often also borrow money even when they have a cash surplus and reserves in the bank. This is done as a way to keep the cash available for their day to day activities and should be done as part of a diversified funding strategy.

What a lender will expect to see

Lenders will need to be convinced about the charity's ability to repay the loan as well as their need for it. The following is a summary of items that the lender is likely to request:

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- The amount of loan required
- Proposed period of repayment
- Constitution (the set of rules for the charity)
- Audited accounts (2 to 3 years)
- Current management accounts
- Business plan (including strategy, organisational structure, CVs of trustees and senior management team)
- Financial forecasts (usually 3 to 5 years)
- Any security that may be available

Many social enterprises and charities will approach lenders experienced in lending to the voluntary community and social enterprise sector, known as social lenders (a list is available at the end of this guide).

Trustee considerations

The trustees of a charity need to be assured of a number of issues before agreeing to borrow money. Firstly, they need to check that their constitution allows them to borrow money. If not, the constitution may need to be amended or else they need to seek permission from the Charity Commission.

If the charity is not constituted as a company limited by guarantee but is a voluntary association (also known as a community group or an unincorporated association), the trustees would be personally liable for ensuring that any loans are repaid. In this case, they may wish to consider limiting their liability by converting the voluntary association into an appropriate company structure. (See the Legal Structures guide).

Borrowing money is always a risk in case of default in repaying the loan. The trustees need to be sure that the charity will be able to meet its debt obligations. In order to do this they will need to be convinced about:

- the reason for borrowing
- the ability to repay the loan and interest charges
- the existence of an adequate financial management and reporting system in place to manage the finances of the charity.

Therefore, the trustees will need to be as convinced as the lenders by the charity's business plan. Trustees are also legally required to take external advice from professional advisors before accepting any loans and this should be documented. Most lenders are aware of this and will help with completion of the paperwork.

The terms of the loan will need to be examined in detail to ensure that the amount borrowed, the associated cost and the time period for repayment is appropriate. Trustees will also need to know whether the lender requires personal guarantees. The majority of social lenders will not ask for personal guarantees but high street banks may do so. A list of social lenders is shown below. The lender may ask for security from the charity, for example its assets, if it has any. If the security to be offered is land held by the charity then permission from the Charity Commission is required.

When a bank loan is not involved

Many charities may not need to take out a loan, and will instead choose to use their existing reserves.

Again, trustees must properly assess whether making a loan to a trading subsidiary is appropriate and whether it will ultimately assist the charity in meeting its charitable objects. They should be satisfied that the trading activities (eg Oxfam shops selling clothes) is viable and will actually generate profits to donate to the charity.

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Things to look out for when borrowing money for charities

Once the trustees decide they do want to go ahead with the new trading arm and lending it money, all actions taken by the trustees should be documented, in particular:

- A loan agreement between the charity and the trading arm should be agreed in writing.
- The charity must charge interest on the loan at a similar rate to what a bank would charge, known as a commercial rate. This ensures that the charity is not loosing out financially by making the loan to the subsidiary.
- The subsidiary must pay the charity the interest due.
- The charity should also ask the subsidiary for a guarantee that it will repay the loan. This guarantee is known as a "charge".
- Where possible the charity should secure the charge against something of value in the subsidiary, so that if the subsidiary cannot repay the loan the charity can take the item of value and sell it to get its money back. Items such as fixed assets or debtors are often used to provide the security.
- Charges such as these should be registered at Companies House, giving the charity the power to take action to recover the debt in case of problems.

Social lenders for charity loans

- Big Invest: www.biginvest.co.uk
- Charity Bank: www.charitybank.org
- Impetus Trust: www.impetus.org.uk
- The Social Enterprise Loan Fund: www.tself.org
- London Rebuilding Society: www.londonrebuilding.com
- Triodos Bank: www.triodos.co.uk
- Venturesome: www.venturesome.org

Further information

Charity Commission, Operational Guidance 22 A1: borrowing and mortgages:
www.charitycommission.gov.uk/supportingcharities/ogs/g022a001.asp

Visit the National Council for Voluntary Organisations website:
www.ncvo-vol.org.uk

Visit the Community Development Finance Associations website:
www.cdfa.org.uk

Visit the Charities Commission website:
www.charity-commission.gov.uk

Read our guides on Legal Structures and Charity Trading:
www.bllondon.com/SocialEnterprise/Legalstructures/SELegalStructures.aspx

Read our guides on Financial forecasts:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Financialforecasts.aspx

Read our guide on Diversified funding strategy:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Sourcingfinance/Developingadiversifiedfundingstrategy.aspx

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