UNDERSTANDING YOUR GIFT ANNUITY PROGRAM

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I. Introduction

Perhaps because gift annuities are viewed as a relatively simple gift vehicle, it can be tempting to look for ways to "jazz up" a gift annuity program. However, because gift annuities pose some financial risk to a charity, the program should be operated with consistent, well thought-out policies and procedures. Understanding what lies beneath those should help avoid unintended consequences from what might otherwise be thought of as isolated or insignificant decisions to vary from those policies.

II. Inherent Risk

When assets are contributed for a gift annuity, the full amount of contribution is likely to be used in giving credit to the donor. This may also be the amount credited to the gift planner, for purposes of their fundraising goals. While this may make sense in these contexts – the donor has in fact parted with that amount – it is important to remember that a gift annuity is a general, unsecured obligation of the charity, and is backed by all of the charity's assets.

When a charity receives a contribution for a gift annuity, the fair value of the contribution is recorded on the charity's financial statement as an asset and the present value of the future annuity payments is recorded as a liability. The difference is contribution revenue. Each year the charity's financials will show the fair value of all gift annuity reserves and the present value of all gift annuity liabilities as of the last day of the fiscal year. The difference between the value of the assets held in reserve and the present value of the liabilities will change from year to year, and the fluctuations will be recognized as changes in the value of annuity agreements.

The ultimate risk a charity faces with each annuity it issues is that the amount contributed could be exhausted before the payment obligation ends. In that event, because the obligation is absolute, the charity would need to draw upon other assets to make the remaining payments, and when the obligation finally ended, nothing would be left for charitable use. This is a particularly disappointing result when a gift annuity has been established to further a particular charitable purpose, rather than simply for the charity's general, unrestricted use. Still, it should be understood that even the most successful gift annuity programs occasionally lose money on a gift annuity.

A related risk is that the financial benefits a charity derives from its gift annuity program will be subpar. An organization can take little comfort in minimizing the number of gift annuities that lose money if it otherwise typically nets only modest amounts. What constitutes a modest residuum? A good working benchmark is anything substantially less than half of the amount contributed. For many decades, the American Council on Gift Annuities (ACGA) has used a target residuum of 50 percent in formulating its suggested gift annuity rates. (In 2011, a 20-percent present value target was added, meaning that at the time the gift is established the present value of the targeted residuum must be at least 20% of the contribution.) Because the overwhelming majority of U.S. charities offering gift annuities follow the ACGA rates, achieving the targeted residuum would likely be an organizational expectation. Results from the recurring surveys conducted by the ACGA since 1994 reveal that charities on average do wind up with more than half of what was contributed for each annuity, though the percentage has

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decreased over the years, from a high of 98 percent in 1999 to 62 percent in the most recent (2017) survey.

There are multiple factors that can create a weaker gift annuity program:

A. Gift annuity rates offered by the charity are too high.
B. Policies regarding annuitant ages and contribution amounts are not in place or not appropriate.
C. Net investment returns are lower than the assumptions on which the charity's rates are based, or gift annuity reserves sustain significant investment losses.
D. Marketing of gift annuities is inconsistent.
E. Individual annuities in the program are not effectively tracked.

No charity can eliminate completely the risks associated with gift annuities, particularly when it comes to factors beyond its control, such as market fluctuations and how long its annuitants live. However, risk can be reduced by establishing and adhering to sensible policies and procedures related to those factors over which a charity does have a control. . . and those will be the focus of this paper.

A. Gift Annuity Rates

According to the 2017 ACGA survey, 97 percent of charities always or usually follow the maximum rates suggested by the ACGA, a result consistent with prior surveys. Beyond use of the ACGA rates, it is important to understand the assumptions that underlie them.

Following are the assumptions underlying the July 1, 2018 rates:

1. The residuum (percentage of contribution remaining for the charity at the termination of an annuity) will be 50%. Additionally, the present value (as of the date of the gift) of the projected residuum will be at least 20% of the original contribution for the annuity.
2. Life expectancies are based on the 2012 Individual Annuity Reserving Table with a 50-50 blend of the 2012 IAR male and female mortality with no age setback.
3. Annual expenses for investment of gift annuity funds and administration of gift annuities are assumed to be 1% of those funds.
4. The total annual return on gift annuity reserves is 4.75 %.
5. The rates for the oldest ages are somewhat lower than the rates that would follow from the above assumptions. Rates are capped at 9.5% for ages 90 and above, and rates for annuitants between ages 89 and 81 are graduated downward from the rate cap.

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6. The compound interest factor for deferred gift annuities is 3.75 %. (Reductions in the factor are made, as needed, for annuities with lengthy deferral periods.)

While a primary goal is to achieve at least a 50% residuum, that result is not the most probable outcome for any given annuity. Why? Because no individual annuity is likely to perform exactly per the assumptions (particularly those relating to mortality and investment earnings). Instead some annuitants will die earlier and some will live much longer than "expected." And investment returns will go up and down through the years – sometimes they will be higher in the years immediately following a gift and then drop, while other times they will drop (sometimes precipitously) right after the gift is made and (hopefully) rebound later. As noted previously, these "timing" issues are completely out of control of the charity – you cannot forecast when someone will die, nor can you know with certainty what will happen with investment returns.

However, the average performance of a program overall will come much closer to the ACGA's assumptions presuming, of course, that actions of a program are in line with the assumptions. If a charity's policies and practices differ from those assumptions, it should be expected that the results will also differ. For example, if a charity spends a portion of the gift annuity contribution up front, or if its expenses or investment returns differ from the assumptions underlying the rates, the charity should not be surprised when its residua differs from the 50-percent assumption that underlies the ACGA rates.

If a charity elects to issue at a higher rate than the ACGA suggests, it will need to realize a higher net return on investments (or have lower expenses or annuitants dying earlier) in order to realize a 50-percent residuum. If it does not, then the residuum will be lower than 50 percent. The problem with higher rates can be compounded by the fact that a rate schedule is determined by looking at what is *currently* happening as well as what *has* happened with market-wide investment returns. What *will* happen with these returns after issuance of an annuity is unknown. If what happens after is better than what came before (i.e. investment returns are higher), the charity may well receive a residuum greater than 50 percent (depending on how long an annuitant lives). If, on the other hand, what happens in the market after issuance is worse than what came before, the charity may receive a residuum under 50 percent (again, depending on how long an annuitant lives).

Apart from decreasing the residuum and increasing the risk of exhaustion, a charity needs to consider as well whether offering a higher rate would violate the requirements of any states in which it is issuing gift annuities. New Hampshire specifically prohibits offering annuity rates higher than those suggested by the ACGA at the time the annuity is issued. Certain other states – Alabama, Arkansas, California, Maryland, New Jersey, New York, Tennessee, and Washington – require that a charity put on file a schedule of its maximum rates, and once filed the charity is not authorized to offer rates higher than those in the schedule (until/unless it files a revised schedule of rates with the state). California, in particular, has emphasized the inability to exceed the filed schedule, and views offering a higher rate as a discriminatory rating practice. Even if offering a higher rate would be acceptable to all applicable states, if any of those states has a reserve requirement then the charity will likely need to hold in its reserve account a larger amount of money.

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Note: In certain instances, donors are looking to enhance the charitable benefit of a gift annuity – and their charitable deduction - and will accept a lower annuity rate than the applicable rate based on the charity's published schedule. In those circumstances, there should be documentation that the donor was made aware of the standard rate and voluntarily accepted the lower rate. California requires an addendum to the agreement signed by both the donor and a charity representative. This would be a good practice in every situation where a donor accepts a lower annuity rate than published rates.

Since most organizations adopt the ACGA's suggested rate schedule, the decision to offer a higher rate usually arises in the context of making an exception for a specific gift. Typically, this is prompted by a donor's request, and often in the context of an exceptionally large contribution amount – precisely when you *don't* want to increase the risk to the organization. However, there are some charities that want to establish a rate schedule different from the ACGA's. If it were to be lower rates, the charity might simply lower the rates by a set amount across the schedule (i.e., reduce the rates by two-tenths of a percent (.2), or cap the rates at a lower amount. If, on the other hand, a charity wishes to create a schedule of rates higher than ACGA's, it would be wise to create its own set of assumptions and use those to determine the rates. To just randomly increase the rates by a certain amount, without understanding the expected outcome, is to put the charity at greater risk of having a low performing program and an increased number of underwater annuities.

B. Policies Regarding Annuitant Age and Contribution Amount

Gift acceptance policies in general serve a number of important purposes, providing a roadmap as to the assets and gift vehicles a charity is willing to accept and ensuring that a charity accepts only gifts that advance its mission and match the risk tolerance of its board. Given that gift annuities subject the charity to a payment liability, a prime intent of the policies that govern them is to protect the charity.

While 65 is the most common minimum age (32 percent) for annuitants of an immediate payment gift annuity per the 2017 ACGA survey, a combined 41 percent had a minimum set younger (either 55 or 60), and a surprising 18 percent of respondents indicated they had no minimum age. One problem that arises with younger annuitants is the length of time before the gift is realized, resulting in a lower present value of the residuum. An annuity with a projected large face value residuum, but attached to a young annuitant with a long life expectancy, may have a lower present value than an annuity with a lower face value and an annuitant with a shorter life expectancy. For example, a projected $15,000 residuum for someone with a 30-year life expectancy has a present value of $6,180, assuming an investment return of 3 percent. A projected residuum of $10,000 for someone with a 10-year life expectancy, on the other hand, has a present value of $7,441.

Issuing to younger annuitants can also lead to increased risk; while other factors, such as poor investment performance or payout rates that exceed ACGA suggested maximums, are more likely to be direct causes of an underperforming gift annuity, issuance to younger donors can exacerbate the problem. In such a situation, a long payout period can increase the likelihood of such a gift going underwater, requiring more years of out-of-pocket payments and costs of administration if it does. Although a charity won't have full control over everything that happens

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during the life of an annuity, it can determine the anticipated time horizon that is acceptable before a gift is realized.

For deferred annuities, the earliest date for starting payments should be the same as for immediate annuities. It is common for the minimum age at time of contribution to be set at 10 years younger, so that with a minimum age of 65 for immediate annuities, 55 would be the youngest age at which a contribution could be received for a deferred annuity. For a two-life annuity, both annuitants should meet the age minimum.

As with minimum ages, the concern with small contributions is primarily a matter of considering the present value of the residuum that is to be realized years in the future; that low value may be eaten up by administrative costs. The minimum contribution amount reported in ACGA surveys has been increasing over time; in 2017, 60 percent of charities had a minimum of $10,000 or higher, compared to 43 percent with such minimums in 2009. Organizations with a minimum of less than $5,000 decreased from 19 percent in 2009 to 10 percent in 2017. For comparison, a $2,500 contribution, projecting a 50-percent residuum of $1,250 in 10 years, provides a present value of the residuum of $930. In contrast, a $5,000 contribution with the same assumptions provides a present value of the residuum of $1,860, while a $10,000 contribution provides a present value of the residuum of $3,720.

Charities might also consider whether to establish a policy for a maximum contribution amount (something only 12 percent of respondents to the 2017 survey had done). The healthiest gift annuity programs will have large numbers of annuities issued in relatively similar amounts to distinct individuals. Whether the result of a single large contribution, or smaller repeat gifts, the concentration of large payments to any one individual results in increased risk to the charity. Should the annuity(ies) attributable to that person suffer significant investment losses, or should the person live well beyond life expectancy, there is a greater potential to negatively affect the entire program. This can be offset by setting a maximum amount that can be contributed by any one individual, or by deciding to reinsure any amount that exceeds that maximum. The acceptable amount will vary depending on the size of the charity's program, and also its risk tolerance. In fact, it may not even be a fixed dollar amount, but rather a percentage of the overall gift annuity pool at the time the gift is contemplated. For example, a charity may decide that it will review any contribution that would have an individual receiving 10 percent or more of its total annual gift annuity payments (an exception might be made when starting a program, when new gifts are often larger than 10 percent of the other gifts, but care should still be exercised to avoid concentration by one gift). Consider risk control strategies for these large annuities such as asking the annuitant to accept a lower annuity rate or reinsurance of some or all the annuity.

C. Investment returns/expenses

As noted above, underlying the July 1, 2018 ACGA rates is a net investment return of 3.75 percent. This consists of a 4.75 gross return, less 1 percent for expenses. Either higher than expected expenses or lower than expected returns would result in a lower net return. It is important to keep in mind the underlying 50 percent residuum target. It is not realistic for a charity to expect to earn each year the amount that needs to be paid in connection with all of its annuities for that year; some of the annuity payments will come out of principal.

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It is, however, important to be aware of how the investment allocation of gift annuity assets, and their actual return, will affect the residua a charity receives; investing reserves prudently is the number one way to limit risk. The asset allocation used for the endowment or for charitable remainder unitrusts is generally not appropriate for gift annuity reserves. This is because when equity exposure is too high and values plummet, a charity will have difficulty restoring reserves to an acceptable level because annuity payments, unlike distributions from an endowment or charitable remainder unitrust, are not reduced when market values decrease. At the opposite end of the spectrum are charities that are overly conservative and see a steady erosion of reserves because the resulting meager return is below the return on which ACGA rates are based.

The ACGA uses an assumed asset allocation to determine the gross return figure (40 percent equities, 55 percent 10-year Treasury Notes, and five percent cash). While this allocation is not intended to be a specific recommendation as to how reserves should be invested, it can serve as a guide for the percent of equities in a prudent portfolio. The ideal portfolio for reserves will include both equity and fixed-income investments. The appropriate percentages of each depend, in part, on the financial situation of the charity and the total amount of gift annuity reserves. For example, a large university with significant surplus reserves could prudently invest more in equities than could a smaller charity with modest reserves. In general, though, fixed-income investments should comprise a higher percentage of gift annuity reserves than of endowed funds. Diversification, of course, is advised whatever the portfolio. The fixed-income portion, for example, might include corporate as well as government obligations, and the equity component of stocks in different-sized companies.

Depending on the states in which the charity issues gift annuities, it may also need to account for investment restrictions imposed by the state. Currently just two states (California and Florida) place specific limitations on how the segregated reserve fund is invested; other states are either silent on the matter or direct investment in accordance with a prudent investor standard. In general, the investment restrictions are:

- Corporate bonds generally limited only as to the percentage in any one company, except in California the limit on publicly traded securities applies to corporate bonds as well;
- Stock limited to 50 percent of required reserve assets;
- Mutual funds limited to no more than 10-percent in any one fund (Florida), or considered as part of the stock limitation (California);
- Real estate not permitted as a reserve investment in California and limited to 5 percent by Florida.

Ultimately the appropriate allocation for a given charity should consider the fixed nature and length of its payment obligations, as well as the charity’s risk tolerance. In creating a prudent investment strategy, a charity should consider an asset allocation that strikes the proper balance between risk and potential return, diversification within each asset class, and selection of investments based on expected cash flow needs.

Along with selecting an appropriate asset allocation, it is also important to make sure that expenses charged to the reserve fund are not excessively high. If a charity pays a vendor 100 basis points for investing and administration and charges the reserve fund an additional 75 basis

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points for internal costs, it would need to have a gross return of 5.5 percent (rather than ACGA's assumed 4.75 percent) to realize a 3.75 percent net return. Before deciding on fees, a charity should compare its expected net returns (after subtracting all expenses from a conservatively estimated gross return on reserves) with the net return underlying the ACGA rates. If it uses a different schedule of rates, it should do the comparison using the net return assumed by that schedule.

Whether handled in-house or outsourced, investment returns and expenses should be reviewed at least annually, and adjustments made as needed. While a charity cannot control market fluctuations, it can control the allocation of the assets backing its gift annuities.

D. Marketing Gift Annuities

Just as a charity is unlikely to be successful in timing the stock market, "timing" the issuance of gift annuities is also not likely to be a successful strategy. There is no way to know what will happen with a particular gift annuity based on what happened before it was issued. Many charities opted to put a stop, at least temporarily, on issuing gift annuities after the market events of 2008-09 as they watched the value of their gift annuity reserves drop. However, in the wake of the Great Recession gift annuity rates were lowered and investment returns rebounded. For charities that continued with their gift annuity marketing efforts, the annuities issued during that time may, in fact, turn out to have among the best results. Choosing to pull back can, in essence, "lock in" lower residua, and result in missed opportunities from gifts issued under what turn out to be more favorable circumstances.

In the 2017 ACGA survey, an analysis was made between rapidly growing programs (those that saw an increase of 50 percent or more when comparing the dollar volume of gift annuities in 2017 with that in 2013) and rapidly contracting programs (those that saw a decrease of 50 percent or more). Contracting programs were more likely to report that limitations had been placed on the ability to market gift annuities, or that more restrictive administrative procedures had been put in place that hindered issuance.

The larger the pool of gift annuities and the more evenly spread the timing of when its annuities were funded, the better it can achieve an economy of scale where the results will average out closer to the assumptions. A small pool feels the effects of each individual annuity much more. Consistent marketing efforts and continued issuance over time will balance the risk of the overall gift annuity pool.

E. Tracking Individual Market Values

Technically there is no requirement to track and maintain a record of the individual market value for each gift annuity contract. Payment obligations are fixed, and thus not dependent on the current market value of a particular contract. Still, tracking market values is common for charities that allow donors to restrict the gift annuity residuum to a specific purpose, so that there

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will be a known ending value to be withdrawn when the annuity terminates and is utilized for the stated purpose.

Even if all of a charity's annuities are designated for its general purposes, tracking individual values is beneficial for two primary reasons: 1) it allows for accurate withdrawal of funds when an annuity terminates, and 2) it allows for better monitoring of the overall health and profitability of the gift annuity program.

Absent actual market values, the amount to be withdrawn at termination must be determined through some other method. If the charity is subject to state reserve requirements, sometimes it will use the reserve liability as the withdrawal figure; but this calculated liability simply determines how much must be held to meet, at a given point in time, the future payment obligation, given the annuity rate, the annuitant's age, and a specified mortality table and interest rate. It is disconnected from what has actually transpired as far as actual earnings (or losses) and whether the person has lived longer than was expected at the time of the gift. Thus, using the reserve liability to withdraw at termination can result in too much or too little being taken out. Sometimes the charity will instead periodically take a distribution of the excess above what in aggregate it is required to hold in the reserve fund. But this, too, makes it likely that for any given annuity the amount being distributed is too much or too little. While for the purpose of an unrestricted gift this may not matter, it does make a difference in assessing the health of the program.

If a charity is taking out too much when annuities terminate, it is withdrawing funds that are in part attributable to annuities that are still in force. This can increase the likelihood that a charity at some point will need to pull general assets later to meet state reserve requirements or to make annuity payments. It can also skew the perception of the health of the program; funds previously taken are often forgotten, and all that is remembered is that general assets were needed to bolster the program. On the other hand, taking out too little when annuities terminate can also skew the perception of the program, giving the perhaps mistaken impression that it is not performing well. It also means the charity is not utilizing the funds in support of its mission as desired by the donors.

As noted above, some charities use state reserve requirements as a way to determine the amount to be withdrawn. Another requirement of certain states is that a charity hold its gift annuity assets in a segregated fund. This practice also provides for better monitoring of the program. Without a segregated account, the contributed assets are frequently placed in one account, while the annuity payments are made from a different account, often without any recognition of the connection between the asset and the liability. Without this connection, it is difficult to document the effectiveness of the program, which can again lead to an incorrect assumption that it is operating poorly and thus should be shut down, or that it is operating smoothly, when in fact there may be policy or procedural issues that could be addressed to make it more successful.

It should be noted that while maintaining adequate reserves to meet applicable state reserve requirements is a positive indicator, doing so does not provide the same detail about the program as tracking individual values. Reserves may be adequate, while still resulting in disappointing residua. A focus on state requirements can also skew the perception of the program in two other ways. The first relates to a charity that does not place the full amount of the contribution into reserve. These "early withdrawals" are often not tracked. When an annuity terminates, the

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charity may be disappointed in the residuum available at that time; and, if the reserve fund drops below the required level and assets must be added later, it may feel its program is a drain on the charity, forgetting that some of the reserve dollars were taken earlier.

The second issue that can arise from focusing on state requirements (rather than tracking individual values) is the decision to take no distributions when annuities terminate. Sometimes circumstances will dictate this action in order to maintain adequate reserves; this was the case in late 2008 and early 2009 when account balances seemed to drop by the day. However, sometimes a charity can become overly fixated on the state requirement, and decide that the more retained in the account the better. Such a build-up of excess reserves related to terminated (as opposed to active) annuities is unnecessary and runs counter to the ultimate goal of the program, which is to use each contribution to further the mission of the charity, as intended by the donor.

III. REINSURANCE

As noted earlier, a charity might elect to reinsure some or all of its payment obligation in the case of a single large annuity or when repeat gifts result in an individual representing a disproportionately large portion of its gift annuity pool. As commonly understood, reinsurance of a gift annuity means using part of the contribution to purchase from a commercial insurance company an annuity that makes payments equal to the payment promised in the gift annuity agreement. The charity effectively transfers the risk, though it is still liable for payments if the insurance company becomes insolvent and the payment obligation exceeds the state guaranty limit. Generally, state laws do not require a charity to maintain reserves for any annuity that is reinsured. (It should be noted that in New York and California "reinsurance" has the more technical meaning of reinsuring the risk, and it is more difficult to arrange. A few insurance companies have secured approval for reinsurance contracts in those states.)

Apart from offsetting risk for large gifts, reinsurance might also be considered in these situations:

a. Reinsurance as a Solution for Problem Annuities

   If a particular annuity has been identified as problematic and at great risk for going underwater (i.e. exhausting the assets attributable to that annuity), a charity might consider reinsurance as a way to minimize the loss. However, in this situation the remaining assets may be insufficient to cover the reinsurance premium. A charity might be willing to use its own funds to prevent an even greater future cost, but may have second thoughts about incurring a present expense and having to tell the donor that absolutely nothing will be available for the intended charitable purpose. Contrary to what charities may suppose, reinsurance is not necessarily a cost-free way to deal with annuities that are severely under-reserved.

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b. Reinsurance as a General Practice

Though not common, some charities choose, as a matter of policy, to reinsure all their gift annuities. They may do so for one of the following reasons:

- Limiting risk
  A charity that is particularly risk averse might choose reinsurance to substantially offload the risk inherent in gift annuities. While reinsurance does not eliminate risk entirely, it does definitely limit it.

- Current need
  A charity in greater need of current dollars, perhaps for a particular initiative or as part of a capital campaign, might choose reinsurance in order to free-up money. While a charity remains ultimately liable for the annuity payments in the event of reinsurer default, the likelihood of such occurrence is small. A charity might then decide to spend (rather than invest during the life of the annuity) the portion of the contribution remaining after paying the premium for the commercial insurance contract, treating that portion as a present gift.

- Donor reassurance
  A small charity with modest assets on its balance sheet might conclude that reinsurance would be comforting to donors.

When considering reinsurance, the advantages – minimizing risk and possibly making current dollars available – must be weighed against the following potential disadvantages:

- Charities generally realize more financial benefit from annuities that are self-insured than from annuities that are reinsured. In other words, the portion of the contribution for a self-insured gift annuity remaining at the death of the annuitant is generally larger than the future value of the amount retained by a charity after paying the cost of reinsurance. This could be reversed if the annuitant lives well beyond life expectancy or the charity earns a low return on the contributed assets. Charities certainly do better with self-insurance when annuitants die prior to the end of life expectancy and usually when they live to life expectancy.

- Donors may be disappointed and confused when they learn that the charity retains only a fraction of the contribution. Suppose a donor gives $100,000 for a gift annuity, and the charity advises her that it is using $75,000 to reinsure the obligation and that $25,000 will be used for the designated purpose. Even if the present value of the residuum the charity would have realized with a self-insured gift annuity were no greater than $25,000, the donor perceives herself as giving $100,000, a substantial portion of which will eventually be available for charitable purposes.

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IV. Conclusion

Understanding the manner in which policy and procedural decisions affect a gift annuity program is key to minimizing risk and operating a successful program. The ultimate tool is consistent monitoring over the years, not just in times of market declines. Bull markets can mask problem policies and procedures; the resulting residuum seems fine, and no further review or analysis of the program is viewed as necessary. But even in those times, poor decisions in the areas over which a charity has control may reduce the performance of the program. When the inevitable market downturn comes, it simply makes the situation noticeable. Keeping a consistent eye on the factors within a charity's control will put its program in better position to weather market fluctuations and result in better long- term performance.

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