Gift Annuity Risk Analysis Options

It should come as no surprise that charitable gift annuities feature a measure of risk. Nevertheless, a charity can take steps to maximize the likelihood its gift annuity program will be successful in spite of the potential downsides. The secret lies in understanding the inherent challenges and then assessing how well the program is responding to them.

First a Word about the Risks Faced by Annuitants

Even though the balance of this article will be devoted to addressing the risks gift annuities pose for any charity that offers them, it is worth noting that annuitants, too, encounter some risk. One concern is that the charity will cease being able to make the annuity payments. Of course, an annuitant can generally feel relatively secure in knowing that the payment obligation undertaken by the charity is backed by all of the organization's assets, not just those contributed for gift annuities. In addition, under the law of several states, a charity must maintain a separate reserve account to cover its gift annuity obligations. Still, if a charity's financial situation worsens to the point that no source of funds remains available to draw upon in making annuity payments, the annuitant will probably have nowhere else to turn.

A separate concern is that the purchasing power of the annuity payments will decline over time, perhaps to an undesirable level. Inflation has been a reality in our economy for the better part of a century now, and while it is conceivable the purchasing power of a fixed sum of money received annually might actually increase at some point in the future (as a result of deflationary economic conditions), a prudent annuitant will remain mindful of the greater likelihood of at least some inflation occurring each year for the rest of his or her life. Moreover, an annuity's purchasing power will always be further eroded to some extent if an annuitant lives long enough that all of each annuity payment received from that point on is taxed strictly as ordinary income.

One Main Risk Faced by Charities, Several Contributing Factors

The ultimate risk a charity faces in offering gift annuities is that in one or more cases the amount contributed for a particular annuity will be exhausted before the payment obligation ends. If it's any comfort, even the most successful gift annuity programs experience this phenomenon from time to time. This does not mean, however, that the charities operating those programs simply tolerate such occasional outcomes. Rather, they strive continually to minimize the possibility that any annuity will lose money. Furthermore, doing so is of increasing importance the more a charity issues gift annuities for restricted purposes versus for its general use.

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, American Council on Gift Annuities (ACGA) has used a target residuum of 50 percent in formulating its suggested gift annuity rates. Because the overwhelming majority of U.S. charities offering gift annuities adhere to those rates, achieving a lower

residuum is at least implicitly an unwelcome result. This is especially so given that surveys conducted by the ACGA over the last 20 years reveal that charities generally wind up with more than half of what was contributed for each annuity.

Even in the case of a successful gift annuity program, certainly not every gift annuity the charity issues can be expected to produce a residuum of at least 50 percent. The goal, though, should always be not only to minimize the downside but also to maximize the upside. In other words, whenever solid results are achievable, mediocre results should not suffice.

In setting its suggested annuity rates, the ACGA acts on behalf of charities (as well as annuitants) to address three fundamental risks that underlie the more global risks just discussed: mortality risk, investment risk, and the risk that whatever victories a charity wins in confronting the first two will be squandered by excessive fees and other direct costs of operating a gift annuity program. Although detailed consideration of these three risks is beyond the scope of this article, each deserves a brief bit of attention.

Mortality risk is the possibility that a particular annuitant will live significantly longer than one would expect based on his or her age. The ACGA rates compensate for this risk by increasing the life expectancy associated with each applicable age. In addition, even though ACGA surveys conducted over the years have found that slightly more than half of annuitants are women, the ACGA rates are based on the assumption that all annuitants are women. Since women have longer life expectancies than men, this adds an element of conservatism with respect to male annuitants. Furthermore, with respect to all annuitants, an additional element of conservatism is found in the fact that every annuitant is assumed to be a full year younger than he or she actually is.

Investment risk reflects the possibility that the charity may earn an insufficient return on what donors have contributed for gift annuities. On the one hand, it is not realistic to expect a charity to earn each year the amount that needs to be paid in connection with all of its annuities for that year. Still, a charity should take prudent steps, through diversification, careful investment selection, etc., to maximize its return on the investment of gift annuity contributions, recognizing that the higher the desired return, the greater the risk. With this in mind, each time the ACGA develops or reviews a set of suggested annuity rates, it attempts to factor in a reasonable rate of return a charity can expect to earn on a realistic mix of cash, bond, and stock investments. At present, that rate is a relatively low 4.25 percent. It is based on current interest rates associated with fixed income instruments, as well as on historical returns associated with stock investments, reduced to account for potential poor results during some years.

Expense risk is how one might conceive of the final category of concerns a charity should anticipate. While the charity will certainly incur costs for things such as staff time and marketing materials in the course of conducting its gift annuity program, these sorts of expenses are properly paid with funds other than the assets contributed for annuities. By contrast, fees for investment management and payment processing, along with tax and regulatory compliance, relate directly to maintaining a gift annuity effort. Drawing upon input from various sources, the ACGA's suggested rates assume that each year a charity will devote 1.0 percent of its gift

annuity assets to paying such expenses. This effectively results in a current net rate of return on gift annuity investments of 3.25 percent.

Moreover, the ACGA assumes a charity will not spend any portion of any contribution until the applicable payment obligation has ended. This means that if a charity appropriates some of what a donor has contributed for a gift annuity before the annuity terminates – whether in a lump sum or periodically by means of recurring internal fees that exceed true expenses – this will increase both its investment risk and its expense risk.

To some extent, a charity will be better able to spread risk the more annuities it has, provided it exercises appropriate care in conducting its program. Yet even the very largest programs in the country generally don't benefit from the ability to neutralize mortality risk, obtain superior investment diversity, or control expenses through disciplined efficiency the way that even small insurance companies do. Still, a charity with 20 well-managed annuities probably has less risk than one with 10 such annuities, one with 50 has less risk than one with 20, etc.

Note: Even though the discussion above makes frequent reference to the ACGA and to how it addresses the different forms of risk when it goes about establishing a set of suggested annuity rates, those risks exist regardless of the annuity rates a charity offers.

Assessing the Risk Attributable to Actual Gift Annuities

No less often than annually, a charity should ask itself how its gift annuity program is faring. Ideally, the charity should take into account not only the relative health of gift annuities that remain in force, but also those that have terminated. Indeed, if a charity is trying to determine the overall "profitability" of its gift annuity program, it must be mindful of:

- Current annuities that may be at some risk of exhaustion or of poor performance;

- Those that have now ended but nevertheless managed to result in a healthy residuum, perhaps even a residuum in excess of the amount contributed; and

- Everything in between.

Incidentally, the phenomenon in the second bullet point above can be the case when 1) the sole or surviving annuitant dies only a few years after the gift annuity was established (especially if death occurred during the deferral period associated with a deferred annuity) and 2) while the annuity was in force, the charity kept expenses to a minimum and achieved very good investment results vis-à-vis the size of the payment obligation.

In short, with respect to some of the annuities it issues, a charity may turn out to meet quite successfully the various risks outlined earlier in this article. Still, the charity's focus going forward should be both on trying to minimize the continuing risk attributable to existing annuity obligations and on positioning itself as well as possible to deal with the risk attributable to new obligations it will be undertaking.

Risk at the Pool Level

A charity can get a quick idea of how its current gift annuities are doing as a group simply by comparing the total amount contributed for those annuities with the amount that now remains. The remaining amount should be comfortably more than 50 percent of the contributed amount. If the percentage is less than 50, then the charity knows that even if all its existing annuities terminate tomorrow, they won't hit the target residuum set by the ACGA. Again, however, annuities that have already terminated may have done so with residua well above 50 percent, thereby lessening the overall impact of any disappointing performance among existing annuities.

Naturally, this sort of basic analysis can be performed only if the charity tracks what becomes of gift annuity contributions over time. If the charity simply puts all contributions into its general fund and does not thereafter account for them separately, pretty much all of the analysis options reviewed in this article will not be available. True, it may be possible to figure out after the fact what *would have* become of gift annuity balances had they been tracked, but that can be a daunting endeavor. That said, PG Calc has been able to help several clients recreate individual annuity balances so that they could then track each annuity balance separately going forward.

If a charity must maintain a gift annuity reserve account pursuant to the laws of one or more states, then the odds are good that it will be able to track what has become of its gift annuity contributions. In this regard, the charity will need to ensure each year that the balance in the reserve account is at least equal to the amount mandated by the state(s) in question. If the charity immediately deposits in the reserve account all of whatever is contributed for annuities but later finds it needs to transfer additional assets to the account in order to meet state requirements, that is a very good indication the program as a whole is encountering some difficulty.

Risk at the Individual Annuity Level

While it can be helpful for a charity to get a big-picture understanding of how its annuity contributions have been holding up over time, more valuable insight can often be obtained by looking at each particular gift annuity. To do this, however, the charity will need to track on an annuity-by-annuity basis what has become of each contribution, rather than just what has happened with gift annuity contributions as a whole.

If in fact a charity has done this, then regardless of whether it must comply with the gift annuity reserve account laws of any specific state, the charity can compare how the remains of each contribution stacks up against the reserve amount (determined according to the methodology of whatever state the charity wants to use for measuring purposes). For example, if a charity that tracks its gift annuities individually happens to issue annuities solely to Texas residents, it can nevertheless choose to see how what remains of each contribution compares with what New York indicates is the reserve requirement for that payment obligation. An annuity with a balance exceeding the associated reserve requirement is probably doing okay, whereas one with a balance below that figure might be a candidate for some special attention. Furthermore, when all the results are aggregated, a quick pool-level analysis can be conducted as well. Likewise, independent of what any state might require, a charity should at least try to ensure that its gift

annuity assets exceed whatever its audited financial statement shows as the present value of its annuity obligations.

A separate approach a charity can take is to start with the existing balance for each of its annuities and then project – based on various constant net return assumptions – what will remain at some future point, typically upon the expiration of the current life expectancy (either single-life or joint-and-survivor) of the annuitant(s) of the annuity. Those annuities for which negative balances are projected will be the ones of most concern to the charity. Here again, combining the results will allow the charity to see projections for its entire pool of existing annuities. In addition, the projections can be analyzed in order to forecast what residua the charity might expect to realize each year in the future as annuities end or what amounts it may need to tap from other sources as annuities exhaust their contributions.

A final approach is to subject some or even all of a charity's annuities to a Monte Carlo analysis. In this case, one is concerned not with projections but, rather, with probabilities. The usual Monte Carlo analysis features 1,000 or more scenarios in which randomized mortality results for someone the age of a given annuitant are paired with randomized investment outcomes for different asset classes based on the extent to which the charity's annuity funds are invested in such classes, as filtered through historical results for each class and adjusted for expenses. The charity can then get a sense of how likely, on balance, a particular annuity will be to exhaust its contribution, wind up with a residuum equal to at least X dollars, at least Y dollars, etc.

Conclusion

Much of the analysis a charity might perform can be conducted in-house or with the assistance of a financial institution the charity uses to manage its gift annuity assets, especially when annuities are tracked using software such as PG Calc's *GiftWrap*. As the charity reviews the results, it will be in a position to look for patterns and trends. For instance, if annuities established during a particular time period or for annuitants of certain ages are doing particularly well or particularly poorly, the charity can identify causative factors and then determine those over which it may be able to exercise greater control going forward, whether by adjusting its policies, its marketing focus, or its investment and administration practices. Likewise, the charity may be able to define situations in which risk should be addressed through reinsurance or through speaking with certain annuitants about the possibility of voluntarily terminating their annuities in order to preserve/accelerate the charitable benefits.

In all of these things, PG Calc can bring considerable expertise to bear for the benefit of charities that offer gift annuities. We frequently perform risk analyses that vary in scope. We also can conduct a more extensive program audit that considers not only the numbers but also policies and procedures, outreach to potential donors, and state regulatory compliance.