An Analysis of Commercial Insurance as an Alternative Gift Annuity Financing Option

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Nonprofit professionals are reluctant to even consider commercially insuring a gift annuity while insurance salespeople claim it is a panacea solution. Is one faction correct or do both arguments have salient points?

TERMS

The term reinsurance has traditionally been used by the nonprofit community to describe this financing technique. Strictly speaking, however, **reinsurance** is a risk transfer arrangement between insurance companies—essentially insurance for insurance companies. While there are some similarities with a commercially insured gift annuity, a nonprofit purchases an annuity from a primary insurer that, by definition, is not a reinsurance contract. Therefore, the term "commercially insured" will be used throughout this study.

PURPOSE

To empirically document when, if ever, commercially insuring a gift annuity obligation is fiscally beneficial to a nonprofit organization.

METHODOLOGY

Using data drawn from the *1994 American Council on Gift Annuities (ACGA) Survey,* we ran side by side comparisons of two gift annuity options: self-insuring vs. commercially insuring. *Currently, only 6.4% of all gift annuities are commercially insured.* For the purposes of this analysis, and under the commercial annuity option, the nonprofit organization invested in either a separate or endowment account maintained by the organization.

SCOPE

First, we conducted a 10-year comparative analysis. Second, we analyzed data over the last 20 years. Finally, we constructed a current gift illustration based on historical investment return models and prevailing market factors.

This study provides insights to the following questions:

- When, if ever, does commercially insuring produce enhanced returns?
- What variations are found in immediate annuity products that might influence the decision?
- Does the size of the nonprofit make a difference in this analysis?
- Is there a standard spread between gift annuity reserve returns and endowment or separate account returns that would be a feasibility indicator?
- What other subjective (non-financial) elements should be considered when making this decision?
- How does statutory regulation influence the decision?
- What caveats exist when commercially insuring?

Key Variables: The strength of any study is correlated directly with the soundness of the underlying assumptions. For this reason, we have dedicated a substantial portion of this paper to articulate the rationale supporting our key variables. The accuracy of our objective analysis will depend entirely upon the validity of the annuity product selected, the investment assumptions and other critical factors.

ANNUITY PRODUCT SELECTION

The annuity product selection was the most critical component of this project. The following section describes the logical progression we employed to reach our final recommendation.

Type—Fixed or Variable: We first had to choose between a fixed single premium immediate annuity and a variable single premium annuity contract.

A **fixed single premium immediate annuity** guarantees a fixed payout to the annuitant in exchange for a single lump sum premium. The nonprofit could purchase this product to provide the gift annuity payment and invest the remainder.

A **variable single premium annuity** provides minimal guarantees, if any, but allows the owner to allocate the investment in a variety of mutual funds or separate accounts (e.g., equity, debt and cash). The account is credited with the mutual fund returns allowing the investor to share in the gains or the losses. The nonprofit could presumably withdraw a periodic amount necessary to make the annuity payments leaving the remainder invested. While this sounds like a reasonable option, we believe nonprofits would invest very conservatively, realizing that even on market corrections, the organization still must guarantee the payment. Also, the internal account expenses (mortality, administration, separate account and investment management) can be greater than $2\frac{1}{2}\%$ annually. In many cases, this tends to make the aggregate cost greater than the potential benefits.

We chose to conduct our analysis, therefore, using a fixed single premium immediate annuity.

Payout Options: Next we had to choose between a straight life annuity, a life annuity with period certain (5-10-20 years) or a cash refund annuity. These options are described below.

With a **straight life annuity**, a premium is paid to the insurer to guarantee a fixed payment to the annuitant for life. If the annuitant dies after receiving only one payment, the insurer profits. Conversely, if the annuitant lives past life expectancy, the insurer must continue to make payments. This is the least expensive option available.

A **life annuity with period certain** obligates the insurer to pay the annuity over the life of the annuitant, but upon premature death, will guarantee beneficiary payments for a specified period of years. To illustrate, a charity purchases a life annuity with five years period certain on a 75-year-old female. If she were to die on the policy's second anniversary, the charity would continue receiving payments for three additional years.

Similarly, a **cash refund annuity** protects the charity against premature death by refunding the difference between the original premium and the payments that were made to the annuitant. As in the last example, a charity purchases a $25,000 cash refund annuity on the same 75-year-old female. If she were to die on the policy's second anniversary and only $5,000 has been paid, the charity would receive a lump sum payment of $20,000.

In addition to the aforementioned payout options, other arrangements exist (e.g., period certain without life contingencies, installment refund, joint and full survivor, etc.). Clearly, these options do not come without an additional premium cost but if the charity is concerned about an annuitant's premature death, these features can be useful in mitigating such risk.

For empirical purposes, however, the straight life annuity was chosen. This decision was predicated on insurance's **law of large numbers**. This law holds that as the number of annuitants increase, the mortality experience of the group will eventually cluster at life expectancy. Said another way, while some annuitants might die five years prematurely, others will die five years past life expectancy. We concluded that for this study to be indicative of the aggregate gift annuity market, a straight life annuity should be used. Next we describe our individual annuity selection process.

Annuity Market Variation: After deciding upon the fixed premium straight life annuity, we made our company choice based upon the following criteria.

- The life insurer must rate A++ by A.M. Best and receive the highest rating from at least one other rating service (i.e., S&P, Moody's, Duff & Phelps or Weiss Research).
- The life insurer must have been in continuous operation for a minimum of 75 years.
- The life insurer must be licensed in at least 48 states.
- The life insurer must rank in the top 50, based on asset size.

The group of companies that remained exhibited safety, longevity, breadth of operations and a large asset base. From this sampling, we searched for a product with the features listed below.

- The annuity product could be issued as a group or an individual contract.
- The annuity product had all of the payment options available to the charity (e.g., cash refund, period certain, etc.).
- The annuity product could be individually underwritten.[1]
- The premium must be in the top 25% of peer group companies.[2]

The products that survived this filter exhibited low expense ratios, flexibility, potential discounts and competitive pricing. As expected, the premiums for this group ran the gamut. The single premium required to commercially insure a $100,000 gift annuity for a 75-year-old male in 1995 is seen in Table 1.[3] This policy would pay the ACGA suggested 8.4% or $700.00 at the end of each month for life.

TABLE 1 MALE, 75	Single Premium	Percentage Cost to Insure
Company A	$61,837	61.8%
Company B	$65,666	65.7%
Company C	$69,860	69.9%
Company D	$69,513	69.5%
Company E	$65,543	65.5%
Company F	$65,604	65.6%
Company G	$66,922	66.9%
Company H	$69,930	69.9%
Company I	$69,238	69.2%
Company J	$65,056	65.1%
Company K	$72,539	72.5%

Looking at the universe of companies, without regard to safety ratings, premiums ranged from a low of $55,336 and a high of $77,008. Companies that were the cost leader among males tended to be similarly competitive among females. We illustrate this by reviewing the premium required to commercially insure a $100,000 gift annuity for a 75-year-old female in 1995. The results follow in Table 2.

TABLE 2 FEMALE, 75	Single Premium	Percentage Cost to Insure
Company A	$71,575	71.6%
Company B	$74,310	74.3%
Company C	$79,636	79.6%
Company D	$80,091	80.1%
Company E	$74,627	74.6%
Company F	$79,007	79.0%
Company G	$77,434	77.4%
Company H	$79,365	79.4%
Company I	$79,636	79.6%
Company J	$73,918	73.9%
Company K	$81,395	81.4%

As in the case with males, premiums in the aggregate market ranged from a low of $66,922 to a high of $94,980. Interestingly, companies that specialized in the 70 and under market did not always fare as well against peer companies in the 70+ market. Competitive life insurers changing interest rates as often as every other day with others changing interest rates quarterly further exacerbate this situation. Our analysis represents a snapshot in time, so clearly the market leaders of today may have had lackluster products only a few years ago. Tables 1 and 2, represent actual market rates as of July 1, 1995.

We reviewed these top-tier companies and chose the product that exhibited the highest overall value.

INVESTMENT ASSUMPTIONS

After selecting the annuity product, we had to ascertain realistic investment assumptions for the separate account, endowment account and self-insured annuity reserve fund.[4]

Self-Insured Annuity Reserve:[5] The average current investment allocation reported for annuity reserves was 40% equity, 50% debt and 10% cash.[6] Assuming the same portfolio over the last five years, using the respective indices, we computed an average net yield of 12%. The self-reported net average, however, was 9.84%. A number of factors could be responsible for this discrepancy (e.g., poor investment management, more conservative allocation, high administrative expenses or misreported returns).

To derive a base average investment allocation for a multiple time period analysis, with the objective of comparing apples to apples, an allocation of 10% equity, 70% debt and 20% cash was used. Using this allocation for the self-insured option over the last five years, we were able to generate an average return of 10.32% versus the reported 9.84%. The same allocation over 10 years yielded 10.90% versus the reported 10.95% and over one year yielded 8.38% versus 8.45%. *The assumption is that this average allocation benchmark can be universally applied for the 20-year and 10-year past to present calculations.*

The allocations were changed, however, to 60% equity, 30% debt and 10% cash for all iterations that involved current to life expectancy calculations (including any 20- and 10-year illustrations with post 1995 life expectancies). We decided to make this change with the rationale that the relatively poor performance of the past should not be extrapolated to predict future returns. This more conservative approach assumes charities will either improve endowment returns within the existing asset classes, or will adjust to a more aggressive allocation in the future (i.e., higher equity weighting).

Separate Account: We also assumed that a more aggressive investment strategy would be followed under the commercial insurance option than the traditional self-insurance strategy. The rationale backing this theory is that the nonprofit has now

shifted 99% of the risks to the insurer (mortality and investment) and can now seek to generate maximum returns to life expectancy.[7] Based on this premise, an average investment allocation of 75% equity and 25% debt would represent a prudent balance. Moreover, we assumed these funds would be invested separately from the nonprofit's common endowment fund. The separate account could strive solely for growth because the periodic payments are completely provided by the commercial annuity contract. Endowments, on the other hand, typically have a dual investment objective—growth and income.

Endowment Account: Given that the nonprofit may find it more convenient to invest the remainder (gift portion) of the annuity in its endowment, we have illustrated this option as well. We assumed the average long-term investment allocation for the endowment fund would be 60% equity, 30% debt and 10% cash. Note that this allocation is identical to the current-to-life expectancy for the self-insured portfolio.

OTHER CRITICAL ASSUMPTIONS

We also considered other critical assumptions such as the mortality schedule, the annuity administration expenses and the annuity payment frequency.

Mortality: To remain consistent throughout this study, we based our life expectancy calculations on the Annuity 2000 mortality table which has been adopted by the American Council on Gift Annuities for their payout calculations.[8] The annuity contracts are priced relative to the insurer's internal mortality table that frequently varies.

Annuity Administration Expenses: The annual investment return of the self-insured account was reduced by 75 basis points to reflect administration expenses. The present value of the commercially insured fund (separate and endowment accounts) was reduced by 1 1/2% to cover any future expenses.[9] The commercially insured option does not have the same reporting, reserving and administrative requirements typically associated with the self-insured method. The assumed expense ratio, therefore, has been adjusted accordingly.

Annuity Payment Frequency: Historical commercial annuity information was only available for monthly payments. This payment frequency adds approximately 3% to 4% to the single premium compared with a semi-annual payout and 6% to 8% with an annual payout. Also, our investment analysis is a function of past annual rates of return that will deflate account values contrasted against semi-annual numbers. We make this distinction because the ACGA's actuarial formula assumes a semi-annual payment; therefore, our illustrations will be conservatively understated.

If our assumptions are sound, the following objective analysis should provide a credible indicator as to the viability of commercial insurance.

TABLE 3 Historical Market Returns	Equity Index Returns	Debt Index Returns	Cash Returns
1995	37.40%	18.20%	5.82%
1994	1.10%	-2.70%	3.87%
1993	9.80%	9.70%	3.02%
1992	7.40%	7.10%	3.89%
1991	30.20%	15.20%	6.39%
1990	-3.40%	8.60%	8.32%
1989	31.30%	13.60%	9.40%
1988	16.20%	7.30%	7.47%
1987	4.70%	1.10%	6.49%
1986	18.00%	14.86%	6.60%
1985	31.20%	21.70%	8.06%
1984	6.20%	14.75%	10.57%
1983	21.30%	7.96%	8.94%
1982	20.90%	32.22%	12.77%
1981	-5.20%	5.85%	17.27%
1980	31.90%	2.31%	13.09%
1979	18.00%	1.53%	11.11%
1978	5.80%	0.99%	6.91%
1977	-8.00%	2.64%	4.70%
1976	4.90%	15.20%	5.06%
Historical 1926-1996	**10.50%**	**5.20%**	**3.70%**

OBJECTIVE ANALYSIS

The purpose of the objective analysis is to thoroughly examine a range of gift annuity scenarios. Toward that end, we integrated our assumptions to illustrate the effects on males and females of varied ages over varied time periods. The subsequent charts include residual gift data for a self-insured account, an endowment account and a separate account, respectively.

For all three accounts, we calculated the weighted average returns. Current, 10-year and 20-year debt returns were derived using the *Vanguard Total Bond Index* and current, 10-year and 20-year equity returns reflect the *Vanguard S&P 500 Index*.[10] Cash allocation returns were computed from *Vanguard's Prime Money Fund* over each time period as well. To forecast future scenarios, we used historical asset class returns (1926-1996) from Ibbotson & Associates; common stock 10.5%, bonds 5.2% and T-bills 3.7%.[11] Our actual annuity choice was used for current assumptions, computing the 10-year and 20-year rates using available, high-quality products.[12]

CHART EXPLANATIONS
The following nine charts attempt to convey as close to "real" expected results as possible. A brief description of each chart follows.[13]

SAMPLE CHART GIFT ANNUITY COMPARISON

Female Donor	Age of Donor
Amount of Donation	Original $ Amount Transferred to Charity
Annuity Premium	Cost to Buy Commercial Annuity in $
PV of Comm. Ins. Exp.	Present Value of Expenses (Commercially Insured)
Payout Rate	Percentage Rate for Gift Annuity Payout
Payout	Annual $ Amount of Gift Annuity Payments
Life Expectancy	Life Expectancy in Years and Dates

	Self-Insured Allocation	*Endowment Allocation*	*Separate Account*
Equity	10.00%	60.00%	75.00%
Debt	70.00%	30.00%	25.00%
Cash	20.00%	10.00%	0.00%

TIME HORIZON FOR ACCOUNT BALANCE CALCULATIONS		
PERCENTAGE INCREASE OVER SELF-INSURED ACCOUNT		
Self-Insured Account	*Endowment Account*	*Separate Account*
Life Expectancy Balance	Life Expectancy Balance	Life Expectancy Balance

ACCOUNT BALANCES GRAPHED
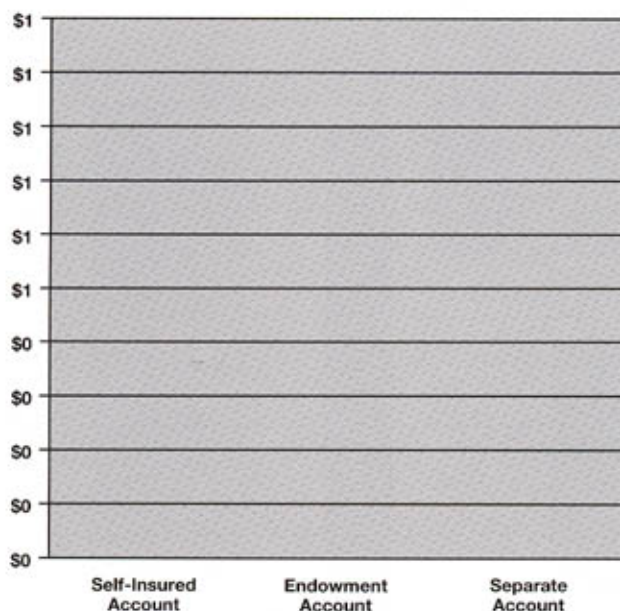
This chart has been included to help explain the subsequent calculations and results. Recall from the investment assumptions section that the self-insured allocation was derived from ACGA survey data. The endowment account assumes the obligation is commercially insured with the gift portion invested in the general endowment. The separate account assumes the obligation was commercially insured with the gift portion invested in a more aggressive separate account. All of our charts that used actual investment return data ran year-by-year numbers rather than average period returns.
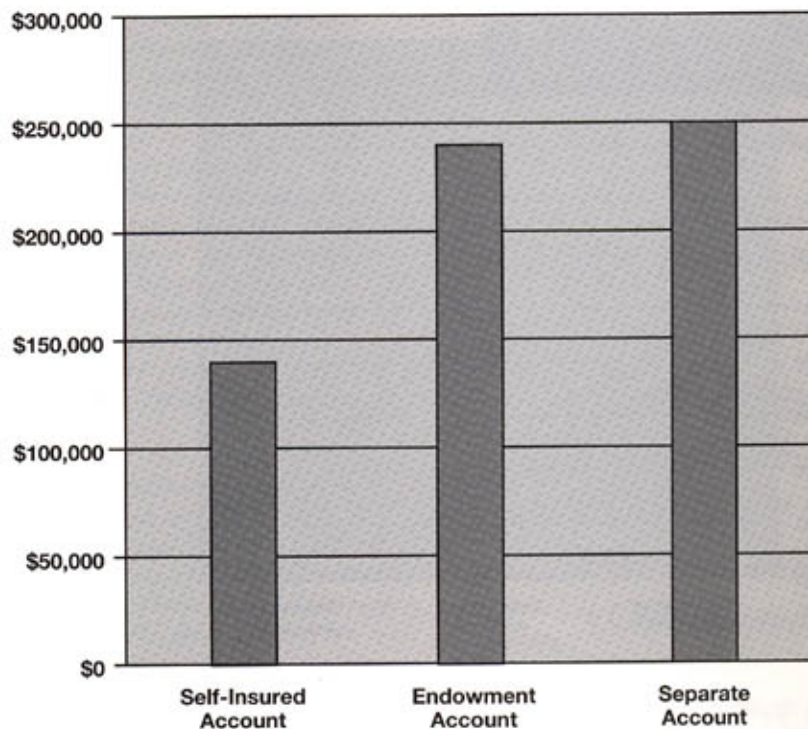
Chart 1 - Gift Annuity Comparison

Male Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$51,031.67
PV of Comm. Ins. Exp.	1.50%
Payout Rate	7.40%
Payout	$7,400.00
Life Expectancy	15.17 (1976-1991)

	Self-Insured Allocation	*Endowment Allocation*	*Separate Account*
Equity	10.00%	60.00%	75.00%
Debt	70.00%	30.00%	25.00%
Cash	20.00%	10.00%	0.00%

1976 To Life Expectancy (1991) Account Balances		
	(173.21% increase)	*(182.42% increase)*
Self-Insured Account	**Endowment Account**	**Separate Account**
$136,736	$236,848	$249,431

1976 TO LIFE EXPECTANCY (1991)
ACCOUNT BALANCES

This chart illustrates what would have happened if a 75-year-old male contributed to a gift annuity in 1976. Account balances represent actual returns through life expectancy (1991), and the annuity premium reflects an actual product at that time.
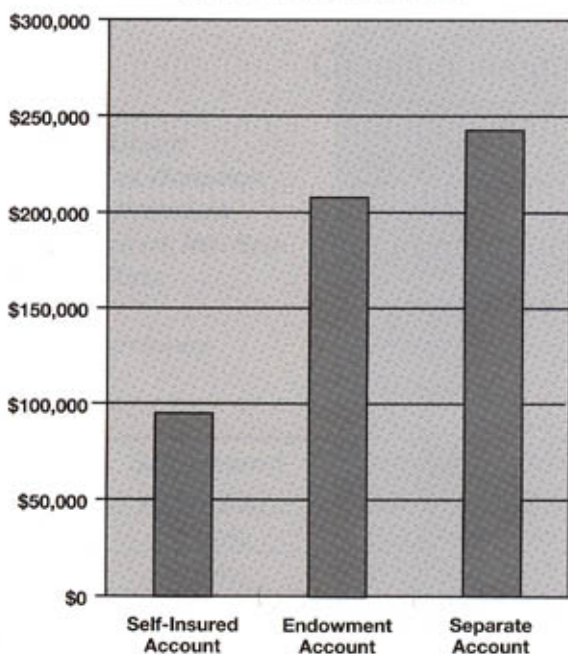
Chart 2 - Gift Annuity Comparison

Male Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$54,424.38
PV of Comm. Ins. Exp.	1.50%
Payout Rate	8.50%
Payout	$8,500.00
Life Expectancy	15.17 (1986-2001)

	Self-Insured Allocation	Endowment Allocation	Separate Account
Equity	10.00%	60.00%	75.00%
Debt	70.00%	30.00%	25.00%
Cash	20.00%	10.00%	0.00%

1986 To Life Expectancy (2001) Account Balances		
	(128.10% increase)	(162.38% increase)
Self-Insured Account	*Endowment Account*	*Separate Account*
$91,686	$209,135	$240,568

1986 TO LIFE EXPECTANCY (2001) ACCOUNT BALANCES

This chart illustrates what would have happened if a 75-year-old male contributed to a gift annuity in 1986. Account balances represent actual returns until 1996 and then historical averages to life expectancy (2001). The annuity premium reflects an actual product at that time.
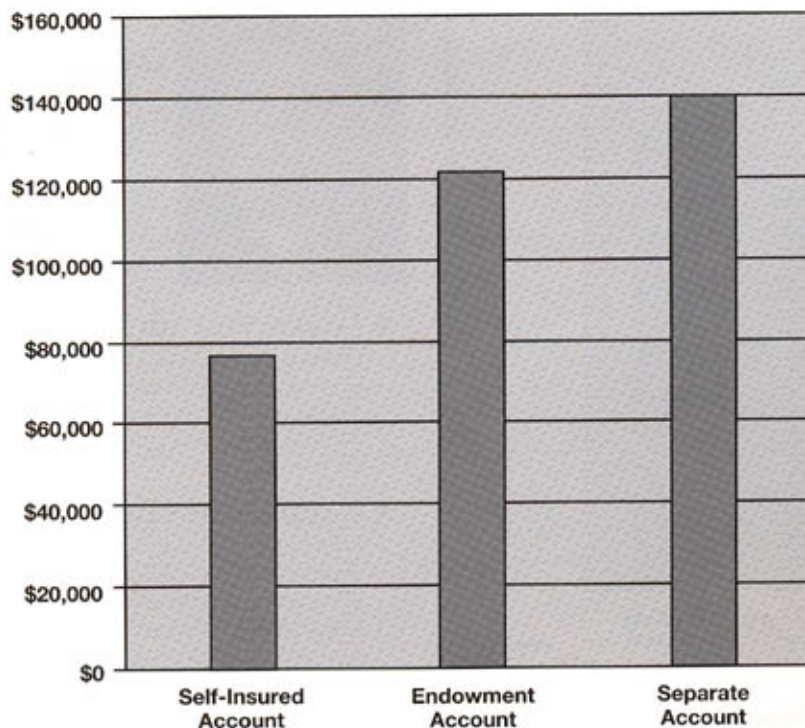
Chart 3 - Gift Annuity Comparison

Male Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$61,837.46
PV of Comm. Ins. Exp.	1.50%
Payout Rate	8.40%
Payout	$8,400.00
Life Expectancy	15.17 (Current-2011)

	Self-Insured Allocation	*Endowment Allocation*	*Separate Account*
Equity	60.00%	60.00%	75.00%
Debt	30.00%	30.00%	25.00%
Cash	10.00%	10.00%	0.00%

Current To Life Expectancy (2011) Account Balances		
	(161.06% increase)	*(183.76% increase)*
Self-Insured Account	*Endowment Account*	*Separate Account*
$75,561	$121,696	$138,852

CURRENT TO LIFE EXPECTANCY (2011)
ACCOUNT BALANCES

This chart illustrates what would happen if a 75-year-old male contributed to a gift annuity currently (1995 for the purposes of this paper). Account balances represent historical returns through life expectancy (2011), and the annuity premium reflects a current product.

Chart 4 - Gift Annuity Comparision

Female Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$60,522.79
PV of Comm. Ins. Exp.	1.50%
Payout Rate	7.40%
Payout	$7,400.00
Life Expectancy	17.19 (1976-1993)

| | 1976 To Life Expectancy (1993) Account Balances | |
| | (166.77% increase) | (180.71% increase) |
Self-Insured Account	Endowment Account	Separate Account
$149,871	$249,940	$270,825

	Self-Insured Allocation	Endowment Allocation	Separate Account
Equity	10.00%	60.00%	75.00%
Debt	70.00%	30.00%	25.00%
Cash	20.00%	10.00%	0.00%

1976 TO LIFE EXPECTANCY (1993)
ACCOUNT BALANCES

This chart illustrates the same scenarios as chart 1 using a female donor.

Chart 5 - Gift Annuity Comparision

Female Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$60,655.36
PV of Comm. Ins. Exp.	1.50%
Payout Rate	8.50%
Payout	$8,500.00
Life Expectancy	17.19 (1986-2003)

| | 1986 To Life Expectancy (2003) Account Balances | |
| | (238.75% increase) | (279.49% increase) |
Self-Insured Account	Endowment Account	Separate Account
$88,243	$210,676	$246,634

	Self-Insured Allocation	Endowment Allocation	Separate Account
Equity	10.00%	60.00%	75.00%
Debt	70.00%	30.00%	25.00%
Cash	20.00%	10.00%	0.00%

1986 TO LIFE EXPECTANCY (2003)
ACCOUNT BALANCES

This chart illustrates the same scenarios as chart 2 using a female donor.

Chart 6 - Gift Annuity Comparison

Female Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$71,574.64
PV of Comm. Ins. Exp.	1.50%
Payout Rate	8.40%
Payout	$8,400.00
Life Expectancy	17.19 (Current-2013)

	Self-Insured Allocation	Endowment Allocation	Separate Account
Equity	60.00%	60.00%	75.00%
Debt	30.00%	30.00%	25.00%
Cash	10.00%	10.00%	0.00%

Current To Life Expectancy (2013) Account Balances		
	(150.23% increase)	(174.45% increase)
Self-Insured Account	Endowment Account	Separate Account
$69,798	$104,857	$121,759

CURRENT TO LIFE EXPECTANCY (2013) ACCOUNT BALANCES
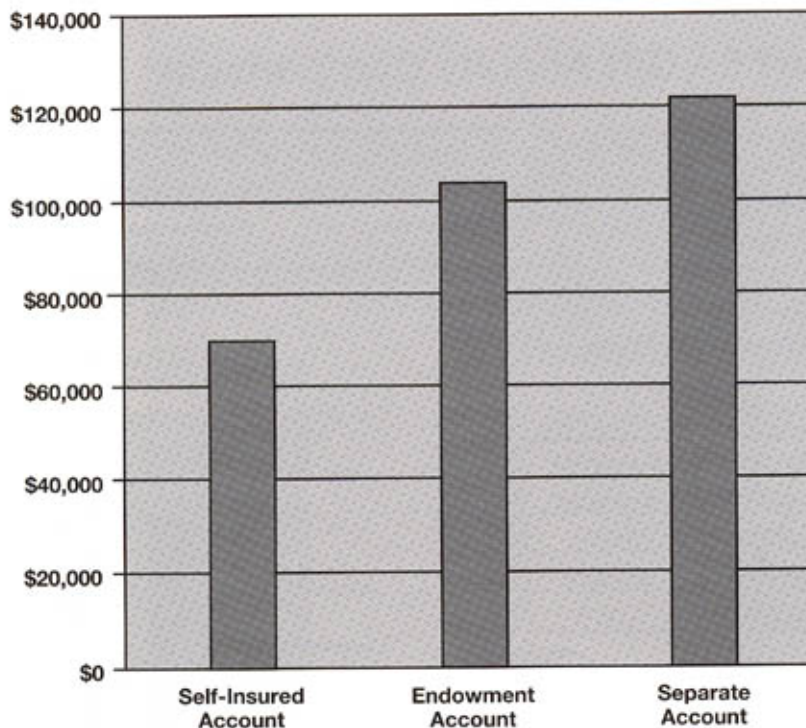
*This chart illustrates the same scenarios as chart 3 using a female donor.*

Chart 7 - Gift Annuity Comparison

Female Donor	75 years old
Amount of Donation	$100,000.00
Annuity Premium	$60,655.36
PV of Comm. Ins. Exp.	1.50%
Payout Rate	8.50%
Payout	$8,500.00
Life Expectancy	17.19 (1986-2003)

	Self-Insured Allocation	*Endowment Allocation*	*Separate Account*
Equity	*60.00%*	*60.00%*	*75.00%*
Debt	*30.00%*	*30.00%*	*25.00%*
Cash	*10.00%*	*10.00%*	*0.00%*

1986 To Life Expectancy (2003) Account Balances		
	(221.58% increase)	*(257.29% increase)*
Self-Insured Account	*Endowment Account*	*Separate Account*
$66,515	$147,381	$171,136

1986 TO LIFE EXPECTANCY (2003) ACCOUNT BALANCES
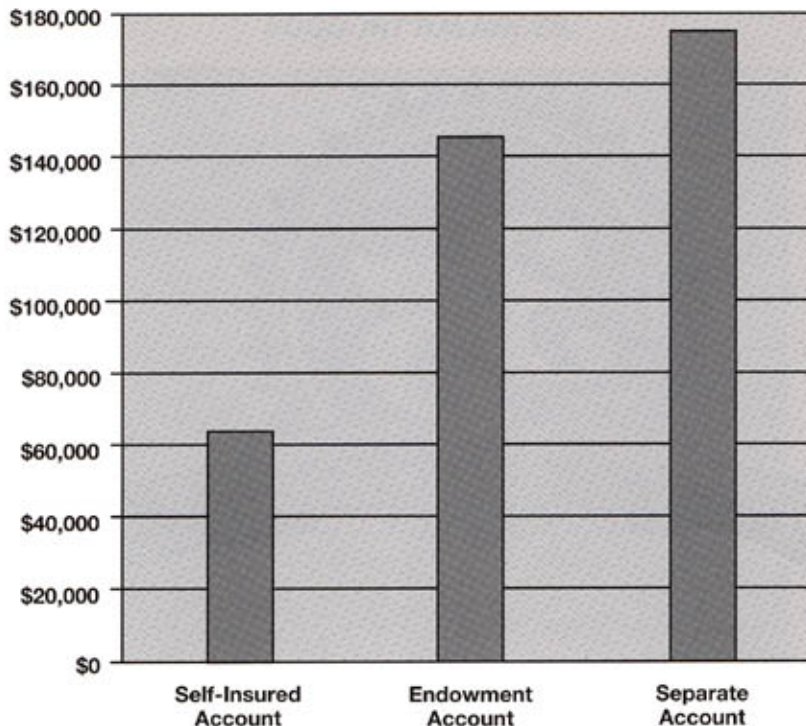
This chart illustrates what we perceive as the average iteration. It uses the average age of a gift annuitant, the predominant sex, the average interest rate environment (therefore, the average annuity cost) and the average long-term investment allocation. We used a 75-year-old female in 1986 using historical return calculations.
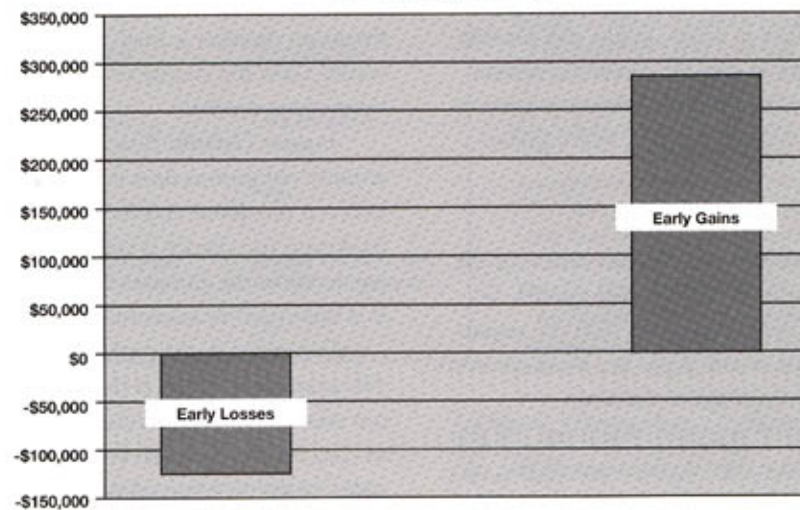
Chart 8 - Gift Annuity Comparison

Female Donor	75 years old
Amount of Gift	$100,000.00
Annuity Premium	$60,655.36
Payout Rate	8.50%
Payout	$8,500.00
Life Expectancy	17.19 (1986-2003)

1986 To Life Expectancy (2003) Account Balances	
Early Losses	**Early Gains**
-$126,349	$285,914

1986 TO LIFE EXPECTANCY (2003) ACCOUNT BALANCES

This chart illustrates the investment risk of the self-insured account. Both of the accounts average 10% over time, however, the "Early Losses Account" suffers annual 10% losses in the first seven years followed by 30% gains for the next seven. Conversely, the "Early Gains Account" has 30% gains over the first seven, with 10% losses for the next seven. Although this may seem to be rather drastic, this substantiates the importance of consistent self-insured returns.

Subjective Analysis: Although the objective analysis provided insightful analytical information, this can not be solely relied upon when making the final decision. The subjective data available could either discount or augment the relative argument for commercial insurance. In this section, we cover the cash flow options, donor preferences and board preferences. Each one of these mutually exclusive variables has the potential to override the quantitative ideal.

CASH FLOW OPTIONS

A nonprofit can realize current dollars under either the self-insured financing method or the commercial insurance method. The flexibility of these cash flows can play an integral part of the ultimate decision.

If self-insurance is practiced, any distributions of the gift portion will increase the risk of default. For example, if the charity withdrew 30% of the initial gift and the donor is still living five years past life expectancy, it is improbable any reserves would remain. In this case, payments would have to be generated by current operating or endowment funds. For this specific reason, many nonprofits are hesitant to withdraw any more than 10% of the gift beyond the reserve requirements.

If the nonprofit opts for commercial insurance, the total gift portion—funds that remain after the annuity has been purchased—can be withdrawn to meet current income needs. The risk of the donor living too long has been transferred to the insurer.

While the available cash flow options may not be of great concern to a large, mature organization, smaller charities may have discounted the gift annuity vehicle because of the lengthy benefit deferral period. The opportunity for immediate cash flow might also be attractive for charities with a crucial short-term

need. Clearly, the nonprofit must choose between current money needs and future money objectives. In addition to internal cash flow choices, the donor might also have strong preferences.

DONOR PREFERENCES

Once again, larger organizations generally have a long history, investment acumen and a sizable asset base. Each of these characteristics is important to a donor considering a gift annuity agreement, thereby making the self-insurance option available.

For small and medium size charities, however, a donor may have default concerns if any one of the aforementioned characteristics is not present. Moreover, such concerns might be exacerbated when the size of the prospective gift is large relative to the nonprofit's total assets. Certainly, if a nonprofit has access to a large community foundation with a gift annuity program, this might be a solution, although this service would not come without potential cost. The commercial insurance option, using companies with billions of dollars in assets, might also provide the additional security necessary to ease the donor's apprehension. This would also allow the nonprofit to keep management and asset control. In addition to donor desires, board preferences play an integral role.

BOARD PREFERENCES

Board dynamics often determine the ultimate course of the nonprofit. For example, a conservative board might prefer the commercial insurance method in an attempt to shift the responsibility. Or the same conservative board might feel more comfortable with the "tried and true" self-insurance method.

Similarly, a board that is more aggressive might feel the self-insurance approach is best because they do not want to give up the assets and responsibility to the insurance company. Or the same aggressive board might not mind giving up the control as long as the charity will benefit in the long run.

This section, unlike the objective report, was not intended to include all of the possible variations. We have attempted to convey the importance of subjective analysis by covering those issues that are most frequently discussed.

CONSIDERATIONS AND CAVEATS

No matter what option is partially or fully adopted, the nonprofit must also consider the potential statutory requirements and the inherent risks.

POTENTIAL STATUTORY REQUIREMENTS[14]

A charity should be cognizant of the statutory requirements where its gift annuitants are domiciled. The following are the more common reserve and investment regulations.

Reserves: Of the 10 states that regulated gift annuities as of December 1994, nine had minimum reserve requirements (typically $100,000). Some states exempt commercially insured contracts from these calculations while others only allow commercially insured obligations in excess of the reserve.

Investments: New York is the only state that specifically prohibits commercial insurance contracts unless they take the form of an insurance treaty agreement (these agreements currently do not exist for charities). Most regulated states have investment rules for the annuity reserves if the nonprofit chooses not to commercially insure, or if it holds statutory reserves. Some gift annuity experts recommend following the stringent New York guidelines just in case the nonprofit ever intends to operate in that state. To comply with New York's investment restrictions, the nonprofit should invest the total investment reserve in treasury bills, notes and bonds. In addition to possible statutory constraints, inherent risks must also be considered.

INHERENT RISKS

The commercial insurance option is not without risk. The nonprofit should be fully aware that commercial insurance is an irrevocable decision and does not release the charity from any ultimate liability.

Irrevocable Decision: Once the charity pays the premium to purchase the fixed single premium immediate annuity, the financing decision is final. Conversely, the self-insured option would allow the charity to commercially insure at any point they deemed appropriate.

Insurer Default: Also, the choice to commercially insure the annuity obligations does not transfer the contractual relationship between the donor and the nonprofit. That is, if the insurer goes bankrupt, the charity is still under contract to continue making payments to the annuitant(s). So, from the charity's perspective, it is important to assess this increased risk.

Determining the probability of a loss event is the first step in risk assessment. What is the likelihood that an insurer that meets our selection criteria would go bankrupt in 30 years? According to Carl Austin, financial analyst at A.M. Best, his best "guestimate" based on prior solvency research was that there was a 99.83% probability of solvency over 30 years.

The second step in risk assessment is determining the severity of the loss. In the event of insurer bankruptcy, other companies will usually acquire the failed firm and assume all of its obligations (liabilities). If this does not occur, the company is placed in receivership by the state insurance department. This insolvency status is typically the triggering mechanism for state guarantee funds. Guarantee associations are present in every state including Washington, D.C. and Puerto Rico, and are intended to provide an additional safety net for policyholders. Specifically for annuities, states generally provide $100,000 of present value annuity protection per owner and $300,000 of aggregate insurance benefits (e.g., life insurance death benefits, cash values and health benefits).

Given the probability of loss and potential severity, the risk of total default might approach one-tenth of one percent (i.e., insurer bankruptcy and no takeover or state guarantee funds). The charity should still be aware that this remains a risk and this percentage does not incorporate possible payment delays or reductions from acquiring insurers or state guarantee funds. This analysis further assumes that the quality of the company chosen is on par with our due diligence insurer listing created from our objective criteria.

TABLE 4 MATRIX	Traditional Self-Insurance	Commercial Insurance
Administration Requirements	High	Low
Revocable Financing Decision	Yes	No
Investment Control	High	Low
Conservative Board	Varies	Varies
Conservative Donors	Somewhat Attractive	Very Attractive
Gift Used Currently	Possible	Very Possible
General Objective Analysis	Reduced Gift to Life Expectancy	Enhanced Gift to Life Expectancy
Small Endowments	Less Attractive	Very Attractive
Large Endowments	Very Attractive	Less Attractive
Due Diligence Requirements	Low	High
Spread Between Credited Reserves & Separate Account	Greater Values if less than 1/2 of 1 percent	Greater Values if more than 1/2 of 1 percent
Mortality & Investment Risk	High	Low

SUMMARY AND CONCLUSIONS

The following matrix provides a comparison summary of the two available options.

The objective and subjective analysis outlined in this paper probably raises more questions than the specific items we attempted to answer. The paper does make clear, however, that commercially insuring gift annuity obligations is certainly a prudent, appropriate financing opportunity under the right conditions. Further, this data provides evidence that many more than 6.4% of annuities should, in fact, be "reinsured" in today's environment. Charities that may not conclude "reinsuring" is in their best interest tended to share certain similarities: larger organizations, well-managed endowments and a desire for ultimate investment control. Conversely, charities where commercial insurance seemed to fit: small to medium-sized, lacked investment acumen, less sophisticated and an interest in using a portion of the money currently. While commercial insurance has inherent caveats, we believe charities should always review the numbers and then make the choice that is in the best collective interest of the charity and the donor. 🔁

Endnotes

[1] Individually underwritten annuities can reflect a higher payout based on increased mortality. For example, if a donor had a heart attack five years ago, a standard policy would be priced based upon an average life expectancy. An individually underwritten commercial annuity, however, would take this medical history under consideration and charge a discounted premium for the desired annuity stream.

[2] Pricing data was collected through *Best's Retirement Income Guide*, 1996, and 1995 *Fixed Annuity Survey Best's Review Life/Health*, July 1995, pp. 54-55.

[3] The average age of an annuitant is 77 years old. See, *Survey of Charitable Gift Annuities*, Minton, Frank, 1994, American Council on Gift Annuities.

[4] All returns are net of investment expenses (e.g., money management, transaction fees, administration, etc.).

[5] This section draws from *Survey of Charitable Gift Annuities*, Minton, Frank, 1994, American Council on Gift Annuities.

[6] Ibid.

[7] The derivation of this 99% figure is explained in the "Insurer Default" section.

[8] The expectancy of life calculations was recommended by Michael Mudry (actuary), American Council on Gift Annuities.

[9] The American Council on Gift Annuities assumes the 75 basis point fee with 1 1/2% estimate per Frank Minton's recommendation.

[10] *Vanguard's Total Bond Index* has only existed since 1986. Because the fund's only objective is to mirror the *Lehman Bond Index*, we used actual index numbers from 1976-1986. We then deducted a 40 basis point management fee annually to more accurately predict past yields.

[11] "A Century of Investing (A Special Report); The Bottom Line: In the Long Run, Nothing Has Beaten the Return on Stocks; but is History a Guarantee of Future Success?" *The Wall Street Journal*, Damato, Karen, May 28, 1996. Section R, p. 10.

[12] Actual annuity rates were gathered from past *Best's Review Immediate Annuity Surveys*, as well as the home offices of insurance companies. Past products were subjected to the same objective criteria we used to filter our current annuity choice.

[13] While the following charts only illustrate donors aged 75, we did run the same illustrations for donors aged 65 and 85. The proportional differences in the account values were the same. All charts are available upon request.

[14] This section draws from, "Gift Annuities: THE Gift Plan for 1994 and Beyond," NSFRE's 1994 Fundraising Day in Washington, D.C., Potter, James B., as well as the "21st Conference on Gift Annuities State Regulations Report," 1992. Note: State regulations are an ever-evolving process and specific state requirements are beyond the reach of this study.
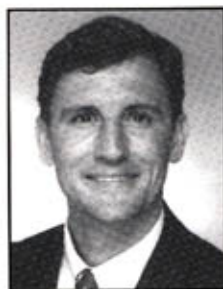
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