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Top 10 CGA Risks to Avoid

BY BRYAN CLONTZ

After performing dozens of risk audits on charitable gift annuity pools from 25-1500 annuitants, I have become increasingly troubled by how charities are managing gift annuity risks. The majority of these pools, regardless of the size, have at least one firecracker, hand grenade and/or nuclear bomb that will do varying degrees of damage to the pool or charity. How can you avoid the risk? Stay out of these top 10 charitable gift annuity traps.

1. Using Money Currently

Spending current money from charitable gift annuities has always been the cardinal sin of gift annuity management, yet charities still do it. Although the equity returns of the '80s and '90s allowed these policies, the whipsaw effect of 2000-2002 has pulled many of these pools underwater — to the point where the present value of assets is less than the present value of liabilities.

Using conservative ACGA assumptions, a new gift annuity has between a 5 and 15 percent probability of exhaustion. And for every 5 percent the charity uses upfront, the exhaustion probability increases by 4 to 8 percent to a total of 35 to 45 percent at 20 percent upfront.

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Teaching Our Children Philanthropy

BY CAM KELLY

If you are like me, you may often wonder if your children understand just how fortunate they are, or whether they are oblivious to the many hardships that can challenge families on a daily basis. I consider myself philanthropically inclined, and I wanted to begin to share that idea and practice with my three young sons. How to do it in a way that is meaningful to them is the question.

Over time my children have observed me putting an envelope in the church basket; pledging money over the telephone when a phonathon volunteer called; writing a check to a charity whose work I respect; or heading off to a meeting at the local YMCA, where I serve on the board of directors. Although they've seen this behavior repeatedly, I wasn't sure they understood the end result of my actions.

As an introduction, I explained that there are families whose decisions are not "What kind of new bike should I buy?" but "Can we afford a new bike when you also need new shoes?" The blatant comparison of want versus need caught them off guard, so I waded slowly into the water. I shared with them that the YMCA needs money not only to keep the building looking nice, but so that children who can't afford a membership or a swim lesson can have one through the generosity of someone else.

In fact, I explained, our family gift to the Y just might help a friend of theirs to have a swim lesson or be able to go to summer camp. Their nods and smiles assured me that I was headed in the right direction in trying to express a difficult concept by using a familiar situation.

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A number of charities, typically community or religious foundations, charge an additional yearly administrative fee of 1 percent or so. On a present value basis, this would be similar to taking between 8 and 10 percent immediately if the donor has a 15-year life expectancy.

2. Granting Rate Exceptions

Similar to taking money currently, rate exceptions are a de facto way of taking the same risk but giving up the benefit. By providing the donor with a higher income than ACGA rates, they are guaranteeing a larger life income and therefore have a larger liability and a smaller surplus.

3. Calling a CGA Pool a "Pool"

Calling any gift annuity pool a "pool" is incorrect for actuarial purposes. First, to benefit from any statistical prediction relative to the law of large numbers, statisticians and actuaries usually like to see homogenous pools of 1,000 lives or greater. Having pools of less than 250 annuitants therefore provides extreme variations in mortality experience. Said simply, charities have no way of predicting when donors will die.

Second, true pools use gains from early deaths to offset losses from later deaths. Charities almost always carve out the pro rata reserve at the donor's death and use the money at that time for unrestricted or restricted purposes. This means that all the actuarial "winners" are pulled out early and are not typically available to back all the actuarial "losers" left in the pool.

Further, if the gift is restricted to a purpose as many gifts are, this does not provide for any flexibility should a group of annuities exhaust. In essence, restricted gift annuities are stand-alone pools (this is frequently the situation in the community foundation or university setting). This would not be the case if a large unrestricted endowment has been board-approved to back gift annuity liabilities.

Third, actuaries like to see very large pools of risks that are equal size and have come in equally over a long period of time. They do not like to see 40 annuitants with an average gift size of $35,000, but with a range of $10,000 to $2.6 million that all came in since 1999. This lends itself to investment timing and annuity concentration risk.

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4. Thinking FASB Liabilities Are Reality

Many charities use their FASB liability reports to assess their pools. The flaw in this analysis is that FASB allows charities to choose the 1990 life expectancy table or the Annuity 2000 table, as well as a reasonable discount rate. In my research, about 65 to 75 percent of charities are choosing the 1990 table and a discount rate of 7 percent. By simply adjusting the assumptions to the Annuity 2000 table plus a gender-specific 1.5 years and using a 6 percent discount rate, charities will find that their asset-to-liability percentage will likely decrease between 15 and 20 percent.

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Best Practices *Continued from page 7*

ical in establishing a charitable gift annuity program since they serve as the overarching policy with the program parameters. Minimum ages and gift amounts drive the operating efficiency of the program.

Establishing the use of the annuity severance funds as a program policy ensures that the remainder funds are well-stewarded in advance of the gift (i.e., for endowment growth or other agreed-upon purpose).

Conclusion

Benefits of a well-managed gift annuity program exist for the charity, as well as for the donor. Donors who lack either significant resources or sufficient confidence in their financial condition are able to carry out their charitable objectives through charitable gift annuities, while also adding to their own financial security. The charity benefits from a charitable gift annuity program because it allows current donors to increase the size of their donations while also broadening the universe of potential donors.

A gift annuity program provides for a highly efficient way to administer a large number of smaller denominated gifts, while satisfying the donor's need for simplicity in a complicated world of tax mitigation and philanthropy. The bottom line is that best practices in managing charitable gift annuity programs truly ensure that the donative intent is met and that the charity has additional resources to meet its own mission and vision. ◆

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So a charity that shows a surplus of 15 percent (or 115% assets to liabilities) may actually have a negative surplus of 5 percent (or 95% assets to liabilities). This is because the 1990 life expectancy table is understating realistic gift annuitant life expectancies between three and five years. This does not include a reduction of 2 to 5 percent for the volatility of investment returns rather than using a constant discount rate.

While FASB and state reserve requirements may allow some flexibility in assumptions, it is critically important to remodel the pool based on more realistic expectations.

5. Investing Too Aggressively in Equities and Not Matching Assets to Liabilities

As more states adopt the prudent investment standard for gift annuity reserves, charities are thinking about increasing their equity exposures.

After reviewing current gift annuity investment allocations, Don Behan, Ph.D., a former Georgia State University actuarial professor and current senior research fellow and consulting actuary said, "A charity that invests more than the gift portion in equity without locking in guaranteed fixed payments to meet the payout liability is speculating." In essence, following this logic, charities should never invest more than the current charitable deduction percentage in equities.

Interestingly, the five largest annuity companies have an average of only 2.8 percent in equities. The remainder is in fixed-income investments that precisely match the expected cash flows. Rather than following this precise approach, charities typically use the same allocation as the endowment even though the endowment has a perpetual time horizon and no liability, and gift annuities have a 12- to 15-year average time horizon with a 60 to 70 percent contractual liability on day one.

Further, charities are not adjusting the allocation to better match the pool liability (if the average life expectancy of a pool is seven years, then that should have a different allocation than a pool with an average life expectancy of 18 years). This would assume the size of all the gifts would be equal, but what if they are not? Does your charity put a 50-year-old $1.3 million deferred annuity into the same allocation as an 85-year-old $10,000 annuity?

6. Relying on History to Project the Future

Of course no one knows for sure, but most of today's market observers aren't calling for the equity returns of the '80s and '90s. With fixed income returns near all-time lows, most financial modeling has become much more conservative than even three or four years ago. And while recent ACGA studies have shown very high residual balances, these reserves benefited from the longest, largest and most consistent bull run in history.

Mathematically, the most harm is done when early losses are successive and withdrawals are being made at the same time. Years 2000 through 2002 would be a perfect example. As has been mentioned, a balanced allocation had a 5 percent exhaustion probability at the beginning of 2000 and a 20 percent exhaustion probability at the end of 2002.

In fact, our research shows that gift annuities written between 1998 and 2002 have between 20 and 45 percent exhaustion probabilities if they were allocated 45 to 65 percent in equities. And this assumes that people will not continue to live longer than the Annuity 2000 table.

7. Self-Insuring "Large" Annuities Representing Concentrated Risk

Charities with smaller pools, restricted gifts, a low risk tolerance or with low surplus continue to write large annuities relative to their pool. If a $10,000 gift annuity were to run out of money, it may not cause organizational harm. If a $1 million gift annuity were to run out of money, it could be devastating.

In some cases, 5 percent of the annuities represent 70 to 80 percent of the assets. This concentration risk is further exacerbated with older donors. At age 75, the longevity risk (the risk the donor lives past life expectancy) becomes much greater than investment risk (the risk that returns don't match assumptions consistently).

Charities should perform some statistical analysis to determine which annuities are large — typically defined as those annuities more than two or three standard deviations from the mean — and then limit the downside while maximizing life expectancy values. Reinsurance, or purchasing a single premium immediate annuity to back some or all of the gift, can be employed to shift the investment and longevity risk to the insurance company.

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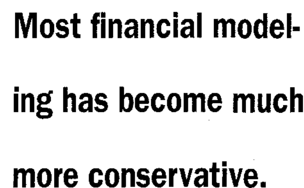

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Although reinsurance continues to be misunderstood in the charitable arena and is either overused (reinsuring everything) or underused (reinsuring nothing), prudent applications of reinsurance can dramatically reduce concentration risk. In fact, it is precisely what life insurance and property/casualty insurance companies do when their risk is too concentrated.

In earlier research, we found the charity would have a larger life expectancy balance by reinsuring and then reinvesting the surplus 100 percent in equity in about 75 percent of the cases if they invested less than 60 percent in equity in their self-insured gift annuity pool.

8. Not Having a Written Risk Management Plan That Matches Risk Tolerance

Before the first gift annuity is offered, charities should set policies to match their risk tolerance based on how much they could afford to lose at different probability levels. They should decide on a risk retention limit (how much they are comfortable self-insuring), a risk reduction limit (the point at which they might try to reduce the ACGA rate) and a risk transfer limit (the point at which they purchase an immediate annuity to back the liability — often called reinsurance). This decision process is identical to the decision a consumer makes when choosing a deductible (self-insurance), a co-insurance percentage (risk reduction) and a stop-loss limit (risk transfer).

For example, after reviewing various ending balance scenarios, a charity might decide that the risk for them becomes too great at $250,000 and therefore will be reduced for gift annuities between $250,000 and $400,000. Beyond that point, they may choose to transfer the risk through reinsurance as the risk on that particular annuity is too great.

A charity with a large healthy pool, a charity with a large unrestricted endowment available to back annuity liabilities, or a charity with high risk tolerance should have a very high risk retention limit such that it may only need to reduce or reinsure risk in 2 to 5 percent of the cases.

When the converse is true, it might be prudent to reduce or reinsure risk in as much as 33 percent or more of the cases. The key is to collar the downside loss based on the pool's attributes and the charity's risk tolerance.

9. Not Reviewing the CGA Pool on a Periodic Basis

One year or one annuity can change everything. In addition, as the pool becomes healthier, risk retention limits can be increased, allocations can be tweaked to better match new liabilities and reserves can be released to meet donative intent.

Or, if the pool becomes weaker, risk retention limits can be decreased, allocations can change as appropriate and reserves can be retained for the benefit of the pool. Finally, because risk itself is not static, the charity should reassess its risk tolerance every few years as well.

10. Charities Thinking That They are Smarter Than Life Insurance Companies

From a strictly financial perspective, gift annuities are nothing more than commercial immediate-life-only annuities that are priced 25 to 40 percent too high. This "overcharge" represents the charitable gift. While the surplus provides the charity with a strong buffer, it can be eroded very quickly through mismanagement, poor investment returns, poor investment timing and long-lived donors.

Life insurance companies do not take money currently; do not make rate exceptions beyond a point that pricing actuaries have deemed prudent; have pools of millions of annuitants; have life insurance pools which are negatively correlated with annuity pools; have teams of actuaries setting rates, monitoring surpluses and asset/liability matching strategies; reinsure blocks of risks that exceed retention thresholds; and review the pools constantly. This should not be construed as advice to transfer all the gift annuity assets to insurance companies, only as a suggestion that many of the same best practices should be followed.

Conclusion

The period of 2000 to 2002 was the perfect storm for gift annuity pools. Unfortunately, the damage will not be repaired any time soon. As most charities are guilty of at least six or seven of these mistakes, they should perform a deeper analysis of their gift annuity pool to better identify risks, develop risk management and investment policies based on the pool's composition and the charity's risk tolerance, and periodically review the pool to make necessary changes. Alternatively, the other option is to just cross your fingers and hope for the best. ◆

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