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Everyone needs to go to the doctor for a checkup now and again. The same can be said for a gift annuity program. Without the benefit of routine assessments, some programs will encounter problems or fail when an early diagnosis could have saved them.

Why Do You Need to Assess Gift Annuity Risk?

There are at least three reasons why you need to assess your gift annuity program.

First, you want to evaluate the current level of risk in the program. Periodic check-ups help you see how the program is performing, adjust where possible, and anticipate what's coming.

A second reason to assess your gift annuity program is to make sure the institution stays out of financial trouble. Having a few individual annuities that are in danger of losing money is not automatically a sign of trouble – even the healthiest of gift annuity programs can have some of these. Since gift annuities are guaranteed obligations of the charity, however, it's important that the pool in aggregate is self-sufficient, meaning that it can support low performing annuities without the need to tap into other assets of the organization.

The third reason to assess the health of your gift annuity program is improve the performance of the program in the future. While some things are out of your control – e.g., market fluctuations and annuitant longevity – you do control many other factors affecting your program: rates, policies, investment allocation, marketing. Identify past actions that are negatively affecting your program's health and make changes to improve the vigor of future annuities. Compare what you do with what others are doing to find best practices.

How Do You Assess Gift Annuity Risk?

A successful visit to the doctor results in a diagnosis and, if necessary, a course of treatment. Likewise, a look at the history of a gift annuity program and assessment of its current condition can determine the health of the program and will indicate future actions.

The single most important data point in assessing the risk in an annuity program is the current market values of the contracts. For a detailed diagnosis, you want the value not just of the pool in aggregate, but of individual annuities. To do so, for each year the contract has been in force, add the investment return and subtract the fees and payments. That should leave you, each year, with the sum of the contracts equal to the total program. If you have been using a software solution like PG Calc's *GiftWrap,* using its CashTrac function, you should have accurate market values for each annuity. If you have not tracked market values, you can use Excel to get a rough estimate using the methodology above. Having individual values allows you to identify patterns among those annuities that are doing well, and those that are performing poorly.

Review the age(s) of the annuitants at the time each gift was completed. Did the gift conform to your gift acceptance policy? Annuities issued to younger donors can often exhaust the original gift. Did the payout percentage of the contracts match the recommended ACGA rate in force at the time? Exceeding the ACGA rates is also a common source of problem annuities. Finally, consider the date of the gift. Was the gift made on the eve of a significant market drop? The wrong timing increases the effective payout from the annuity from which it may never recover.

Predicting Future Performance

One approach to assessing the future performance (or underperformance) of your gift annuity program is to conduct a constant net return projection. Project a range of potential returns, say a low of 2%, a mid-range return of 4%, and an optimistic return of 6%. Project the returns for each contract out to the life expectancy of each annuitant. A year-by-year projection of residua will highlight both annuities at risk of exhaustion and those that expect strong final remainders.

Another way to make these tests more realistic is to offset the ages of a good, current mortality table by a certain number of years. This way you can consider wealth and health and run your model for each contract several years longer than the "expectancy." There are also more sophisticated ways to evaluate the future performance of your gift annuity reserves, involving randomly generated returns rather than a constant return.

Consider your projections at both the individual and the pool levels. Sometimes most contracts will be deemed to be healthy and the others will have no material impact. In other cases, the many healthy contracts may mask the terrible fact that a few bad contracts threaten to be a drain on all the whole pool.

Implementation of Risk Control Strategies

A gift annuity program is a shared risk pool. Some annuities will leave a significant positive residuum, while other contracts may exhaust the original gift amount. The gift annuity reserves must be managed so that the risk of good returns or negative returns is shared across the pool. To account for this variable performance, policies regarding withdrawals from the reserve fund can mitigate risk.

- For example, a charity may decide not to permit annuities to be restricted to an initiative of the charity. In such a case, the reserve fund can retain a portion or all the positive residua from completed annuities, to underwrite the annuities that have exhausted their original gift.

- If restricted annuities are permitted, consider a policy where a percentage of any positive residua from completed annuities is retained in the reserve fund. For example, consider retaining 5% of the residua from all terminated annuities, even if designated by the donor. Disclose this policy to the donor before they complete an annuity contract. The positive residua from undesignated annuities can be retained or distributed from the reserve fund in amounts considered prudent by the investment managers of the fund.

- It is the exceptional program for which the analysis described above would fail to uncover at least some problem contracts. One way to solve the problem of a single annuity contract that poses an extraordinary risk is to remove it from your portfolio, by asking the annuitant to voluntarily reassign the annuity to the charity. The annuitant may be entitled to an additional income tax charitable deduction and the liability is removed from the gift annuity reserves.

- A similar approach is to offer to cash out the annuity. The charity could pay the annuitants a lump sum equal to the present value of the future annuity payments. While this approach may be considered unpalatable to charity, it removes the liability and stops future losses.

Conclusion

Following good policies and maintaining enough of a reserve in the gift annuity fund can keep an annuity pool healthy. Evaluate where the program stands today, project its future performance, and adopt risk control strategies to keep your program out of trouble.

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