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In response to widespread concern regarding the current financial atmosphere, many of our clients are expressing anxiety specifically about their gift annuity programs. Accordingly, we offer the following thoughts regarding gift annuity rates, the reserves backing your annuities, the investment of your gift annuity fund, and additional considerations regarding offering gift annuities in the current environment.

Gift Annuity Rates

The American Council on Gift Annuities (ACGA) recently undertook a thorough review of its suggested maximum gift annuity rates to consider whether it would be advisable to reduce them. After reviewing assumptions and benchmarks, and a model portfolio of 40% equity, 55% fixed income, and 5% cash, it concluded that its expected return assumption for determining maximum annuity rates should remain at 3.25% before fees.

As a result, the ACGA approved a new rate schedule effective January 1, 2012. The ACGA also noted in its announcement that its board will be engaging an actuarial firm to review its current model portfolio asset allocation as well as assumptions and methodology used for arriving at its current schedule of rates for both immediate and deferred payment gift annuities.

We encourage your charity to follow the ACGA's rates. The entire industry benefits from adherence to the ACGA's uniform schedule of rates. Some charities already offer rates lower than the ACGA rates, and certainly any charity is free to adopt a rate schedule different from the one suggested by the ACGA. Remember that the ACGA publishes suggested *maximum* rates.

If you do reduce your rates, any such adjustment should be based on advice from actuaries experienced with gift annuities. Also, you should alert any state department of insurance to which you have submitted a schedule and submit a new schedule with the notification.

Reserves Backing your Annuities

If a significant portion of your gift annuity reserves is invested in equities, it is possible that the fair market value of your reserve assets has dipped below the amount required to meet existing annuity obligations. If you are registered in a state that requires a segregated reserve fund and annual reporting, you might have to transfer general institutional funds into the segregated fund by December 31 so that your annual report can show that your gift annuities are adequately reserved. Even if your reserves remain adequate, the balances for individual annuities may be at a greater risk of exhaustion before the termination of the obligation. This will be of particular concern for those charities that allow donors to establish gift annuities for specified purposes and do fund accounting.

If your gift annuity reserve fund customarily holds only the statutory minimum required surplus, it is likely that you are going to have to transfer more money to your reserve fund. But if you reserved the face amount of each gift and have a balanced portfolio, your reserve may be in better shape than you expect.

We suggest that you:

- Run or request a report of minimum required reserves and compare that to your current gift annuity reserve fund balance. This should be done now and not delayed until just before the end of the reporting year for applicable states.
- Determine the projected balances of individual gift annuities at the end of life expectancies to identify the problematic ones if you permit donors to designate annuities for particular purposes.
- Review the maximum size contract that you will accept. Consider, at least temporarily, reducing the amount you will accept.
- Build your reserve fund by retaining the proceeds from terminated unrestricted contracts. When an annuitant dies or surrenders a contract, hold the termination proceeds in your fund.

Once you have assessed the situation, you can develop a plan of action.

Investment of Your Gift Annuity Fund

It's a good time to review your portfolio your investment advisor. Determining the right investment strategy at this particular time is very difficult, and we will not presume to give you advice on this matter. However, we would remind you that commonly accepted best practices suggest that it is prudent to invest gift annuity reserves more conservatively than your endowment. According to the last ACGA national survey, on average charities invest about 45 percent of their reserves in equities. Some large charities with huge reserves are more aggressive, but many smaller charities invest a smaller percentage in equities. The most problematic gift annuities are the ones where major market losses are sustained soon after the contributions. With a conservative, diversified portfolio, you protect yourself against this possibility to some extent.

Offering Gift Annuities in the Current Environment

Some charities are wondering whether they should suspend their gift annuity programs in light of current conditions. While that would prevent a charity from incurring more liability at the expense of bringing in more gift assets, it would not prevent the risk inherent in existing gift annuities. Although it may seem counter-intuitive, suspending the program at this time could increase risk for the following reasons:

- Gift annuity rates paid on new annuities will be significantly less than the rates being paid on most of the annuities currently on your books. Therefore, these new annuities are likely to result in larger balances.
- If you take in new money for gift annuities and invest it when the market is down, you have a good chance of generating surpluses from the new annuities that can help offset possible losses on the older ones. The annuities that have the healthiest balances today were those established at the bottom of the market in the early years of this decade.
    - For example, if you take in a $10,000 gift annuity with a reserve requirement of $7,000, your net surplus will increase by $3,000 (if you have a reserve deficit, the gift will decrease your deficit by $3,000).

Options?

You may be wondering if you have any options regarding individual gift annuities that are in trouble. You do. Gift annuities are an irrevocable obligation of your organization. However, an annuitant may be willing to assign his or her income interest in the annuity to the issuing charity, thereby accelerating the gift and relieving the charity of some of the financial pressure on the program. An annuitant who makes such an assignment might be entitled to an additional income tax charitable deduction. The donor need not surrender his or her entire income interest. The donor could surrender a partial interest in his or her annuity, resulting in a lower payment obligation and reducing the liability to your charity.

Gift annuities have been around for a long time, and they have survived many recessions. It is understandable to be concerned, but with proper procedures and risk-control strategies, it should still be possible to operate a profitable program. You are invited to contact us if we can help you in this regard.

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