

[admin](#) - Fri, 12/1/2006 - 00:00

Everyone needs to go to the doctor now and again. Getting a checkup on a regular basis is important to good health. The same can be said for your organization's gift annuity program. Without the benefit of routine assessments, your program may not succeed as well as it could.

### **Why assess your gift annuity program**

There are at least four reasons to assess your gift annuity program.

1. To understand the level of financial risk posed by your portfolio of active annuity contracts
2. To identify problem annuities that may warrant specific action
3. To review program costs with an eye toward reducing them
4. To review policies and procedures with an eye toward improving them

### **Understanding your program's financial risk**

Few gift annuity investment pools are run to manage risk. For example, most organizations withdraw the funds backing each gift annuity when the annuity terminates. This means that the funds backing annuities that terminate earlier than expected are not available to help finance the annuities that end up lasting longer than expected. Given this paradigm, it is especially important to understand the risk profile of the annuities in your pool. Once you understand your pool's risk profile, you can take measures to improve it if necessary.

### **Identifying problem annuities**

For example, consider the risk of carrying a 9% annuity for a \$500,000 gift made by a 79 year-old in 2000. 9% was the American Council on Gift Annuities (ACGA) rate for a 79 year-old back then. If your pool has averaged a 4% annual return since 2000 – pretty low, but the last six years have been unkind to most investors – the current market value of the gift has already eroded to about \$300,000. Now your pool has to earn a 15% annual return for that \$300,000 to cover the \$45,000 annuity. If the annuitant outlives her life expectancy by more than a few years, the \$300,000 will exhaust completely and the annuity will end up costing your charity more than the \$500,000 you received. If the annuity represents a significant

fraction of your entire pool, the financial health of your entire pool could be affected.

### **Reviewing program costs**

An assessment can also be worthwhile for reviewing the cost structure of your program. How have the administration and investment management of your annuity funds played out in the past, and are they on the right track for the future? Are you performing your administration in-house when outsourcing these tasks might be a better use of your limited resources? Do you have the right staff and the right amount of staff dedicated to this critically important function?

### **Reviewing policies and procedures**

Once you have assessed the risk in your gift annuity pool, identified any problem annuities, and reviewed the cost structure of your program, you will be in an excellent position to review your program policies and procedures. Do your most problematic annuities share any common characteristics? Do your investment managers understand the purpose and function of a gift annuity pool and is that understanding reflected in their investment choices? Does the cost structure of your program suggest an increase in gift minimums or a change in how you accomplish selected tasks?

### **How to assess gift annuity risk**

There are three critical steps to assessing gift annuity risk.

1. Gathering accurate data on your program's contracts
2. Making informed assumptions regarding the future performance of your gift annuity pooled investments
3. Choosing an appropriate method for analyzing risk

### **Gathering data**

Review your records for accuracy, especially the gender and date of birth of each annuitant, and the annuity amount. One common mistake is to exclude living successor annuitants in the records of current annuities. Even if the successor annuitant has not received any payments yet, he or she is important to the analysis. Similarly, it is imperative that deceased annuitants, whether primary or successor, be removed from the records for purposes of accurate evaluation.

Another area of review revolves around the current market values of the contracts. Before a useful analysis of each annuity contract can be performed, you must know how much principal is associated with that gift. This can be hard to do if the analysis has never been done before. If you or your service provider uses PG Calc's GiftWrap gift administration software, its CashTrac CGA Market Values feature will help you automate this task. If not, Microsoft Excel can do the job.

Lastly, you will want to determine the expected remaining life span of each contract. One straightforward way to do this is to look up the life expectancy of each contract's annuitant(s) in a life expectancy table. You will find tables based on the Annuity 2000 mortality table - the mortality table adopted by most regulating states for performing reserve calculations - on the [PG Calc web site](http://www.pgcalc.com/client/lifetables.htm) (link to [www.pgcalc.com/client/lifetables.htm](http://www.pgcalc.com/client/lifetables.htm)). Alternatively, if you or your service provider own GiftWrap, you can use its Gift Years Remaining report to compute the life expectancy of each of your contracts.

### **Predicting future investment performance**

Review the historical and current investment strategy for your gift annuity pool. Understanding the trends in the investment of your gift annuity pool will help you make assumptions about how its investments are most likely to perform in the future. If your pool is weighted toward equities, for example, you might assume a somewhat higher average annual return, but also allow for higher volatility than if your pool is weighted toward fixed income investments. To get a bead on long-term trends, you may want to consult the historical performance of an index or mix of indexes that correspond well to your annuity pool's investment strategy. The S&P 500 is a popular index of large-cap stocks, for example.

### **Analyzing risk**

Using Microsoft Excel, you can project the performance of your contracts using a straight-line investment assumption, such as 6% net return each year. By assuming each contract will last for the life expectancy of its annuitant(s) and earn your chosen investment return, you can make a crude prediction of when and how much each contract will provide to your organization.

You can improve on this analysis in a number of ways. One easy step is to apply optimistic and pessimistic investment returns to your model. This methodology allows you to define a "best-case" and "worst-case" outcome of each contract.

Another easy step is to adjust life expectancies up or down by a few years to get a sense of how the duration of each annuity may affect how much remains for your organization.

Another way to make your tests more sophisticated is to introduce Monte Carlo simulations. Monte Carlo enables you to estimate likelihoods, such as each annuity contract's risk of exhaustion. Instead of drawing three straight investment-return lines (one high, one low, and one in between) to approximate how a contract will perform, Monte Carlo performs hundreds or thousands of random trials, each trial with an investment return that is centered around an average rate. The advantage of Monte Carlo simulations is that they can show levels of confidence and answer the question of how likely it is that a certain contract will run out of money. This is a better measure of risk than assuming the same investment return year-in and year-out. For example, if your institution's policy of tolerance for a risk of exhaustion is no more than 10%, Monte Carlo analysis will show you whether your program is within that standard.

A second level of sophistication is to randomly generate the number of years each trial in the Monte Carlo simulation is run based on an appropriate mortality table. As a result, some trials will last longer than the annuitant's life expectancy, others less long, and the average trial length will tend to equal it. This is a more accurate way to estimate how long a contract will make payments than assuming a specific life expectancy.

Sorting your results will greatly simplify the process of identifying problem annuities and any characteristics they may share. Useful sort orders include likelihood of exhaustion and number of dollars, negative or positive, each contract balance is predicted to reach at termination. Once you've sorted the problematic contracts together this way, you can test them for common characteristics. Were they given during a particular period of years? Did their annuitants tend to be of similar ages on the date of gift? Are the gifts particularly large or small?

### **Policies and implementation**

Once you have performed your projections and analyzed the results, you can use these results to design specific interventions and inform policy changes.

## **Dealing with individual problem annuities**

One way to solve the problem of a single large annuity contract that poses an extraordinary risk to your entire pool is to remove it from your portfolio. There are at least two ways to do this. You can reinsure the annuity and transfer the risk to an insurance company. This solution is likely to be expensive, given that you have already determined that the annuity is in trouble and any life insurance company is going to see that too. You may also be constrained from reinsuring by state regulations or your organization's own policies.

Another way to remove a problem annuity contract from your gift annuity pool is to ask the annuitants to voluntarily reassign the annuity to your organization. While doing so will necessarily terminate their payments, it will also earn them a charitable income tax deduction in the year of reassignment. The deduction will equal the value of the annuity stream the annuitants reassign, which is likely to be substantial.

Can you “renegotiate” a gift annuity contract to reduce future annuity payments rather than stop the payments? Not always, and generally not in states that require you use the same rates for all donors. Check with your counsel.

## **Policy modifications**

Apart from trying to remedy problem annuities directly through reinsurance or reassignment, your analysis should help you identify similarities among annuities that are doing particularly well. Going forward, you could make a special effort to attract new annuities that fit this pattern. For example, if you find annuities that you have written for your oldest annuitants are also the most vulnerable because they have the highest annuity rates, you could seek gift annuities from donors who are younger and therefore not eligible for such high rates. You also could make a policy decision to place a cap on the annuity rates you offer. Rather than offer what the ACGA suggests at all ages, your organization could offer the ACGA rate as long as it is, say, 9% or lower. All annuitants eligible for an ACGA rate over 9% would be offered 9%. Keep in mind that certain states will want you to submit a revised schedule of your annuity rates if you make this sort of policy change.

A review of your cost structure might suggest that your current minimums for gift amount or annuitant age are too low. The ACGA's 2004 survey of charities that issue gift annuities found that the most common minimum gift amount had increased from \$5,000 to \$10,000 over the previous five years. It seems likely that

this trend has continued. An increased cost of administration is likely one of the underlying causes of this trend.

You should also work with your investment manager to review whether the investments of your gift annuity pool match up well with the obligations and risk represented in your annuity pool. This review should be carried out at a level of sophistication well beyond the scope of this paper. The point is that not only should there be a match between the payment needs of your fund and its investments, but also a match between the risk level of your annuity program and your fund's investment policies. Applicable state investment restrictions may influence the choices made.

Your organization can also use your risk analysis to reconsider the way funds are removed from your annuity pool when an annuity terminates. One way to shore up the ratio of assets to liabilities in a troubled annuity fund is to remove less when an annuity terminates. For example, if your organization's policy is to remove the estimated market value backing an annuity at termination, you could revise this policy downward to 75% of the estimate market value.

While only a few states require issuing organizations to maintain a minimum reserve to back the active gift annuities on its books, you may find it very helpful to track your organization's reserve needs on a routine basis – quarterly or annually are typical – for its own purposes. Regular comparisons of your reserve requirements to the actual balance of your gift annuity fund will help you keep close tabs on the financial health of your gift annuity program and to make adjustments before a small problem becomes a big one.

PG Calc's GiftWrap makes computing reserves simple to do. If you use a realistic interest rate and mortality table in your calculations, the reserve will give you a useful estimate of the funds needed to finance your active annuity obligations. It is wise to add a surplus to the calculated amount to increase your margin of error. Surpluses of 10% to 25% are commonly used, but there is no magic number. Your financial staff will be helpful in determining the interest rate and surplus percentage that is appropriate for your institution.

## **Conclusion**

It is important for your gift annuity program to get a checkup every few years. This review of policies and practices done on a routine basis will help you avoid problems

before they occur and fix any that are spotted before they get bigger. You should also review your annuity pool routinely.

Sometimes, the checkup should be done by an expert who looks at gift annuity programs all the time and is well-positioned to compare your program to other programs. PG Calc has performed this service for a number of charities. At other times, a self-exam will be sufficient to ensure early detection. No matter how you do it, remember that a carefully planned and executed review will not only help you and your colleagues make better decisions, but will protect the best interests of your successor and your institution.

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