Charitable Gift Annuity Reinsurance: The Top Ten Frequently Asked Questions

What exactly is charitable gift annuity reinsurance? Who better to answer this question than charitable gift annuity risk management specialist and PGDC Editorial Board member Bryan K. Clontz? In this article, Bryan answers this and nine other follow-up questions that will help readers understand the applications, benefits and nuances of this valuable management tool.

by Bryan K. Clontz

Over the last decade, I have written articles and given speeches on charitable gift annuity risk management and reinsurance. Prior to the stock market downturn in 2000, most charities saw no prudent reason to transfer the inherent longevity and investment risks of gift annuities. Now, of course, many charities are reviewing their gift annuity pool's health and consequently have become extremely risk averse. Reinsurance can be an excellent risk management tool when used at the right time and in the right amount. In an attempt to remove some of the mystery surrounding what can be a confusing and esoteric topic for both non-profit and for-profit gift planners, I have attempted to summarize the ten questions that I get asked most frequently.

1. What exactly is gift annuity reinsurance?

Charitable gift annuity reinsurance is simply a financing technique whereby a charity chooses to purchase a commercial single premium immediate annuity as an asset to back its contractual life-income liability owed to the donor. The term "reinsurance" is both incorrect and unfortunate in that it has no resemblance to true reinsurance — where one insurance company cedes excess risk to another insurance company for a premium. The term continues to confuse the insurance industry and regulators, but has become ingrained as part of the charitable lexicon.[1]

2. What risks are transferred under this financing alternative and what risks remain?

When a charity receives a donation to fund a charitable gift annuity, the vast majority simply invest the proceeds in a balanced investment portfolio of stocks, bonds and cash, allocated similarly to their endowment. By choosing instead to partially or fully "reinsure" the gift annuity liability with a commercial single premium immediate annuity, they are shifting both the investment risk — the risk that returns are less than had been originally expected over the annuity's life — and the longevity risk — the risk that the donor will live longer than expected. A fully-reinsured life-only immediate annuity pays exactly the contractual gift annuity payment as long as the donor is alive, and therefore transfers both the investment and longevity risks to the life insurance company. Reinsurance also reduces or eliminates concentration and return/payout timing risk as well.

A critical point, however, is that the contractual gift annuity payment remains that of the charity, so if the life insurance company defaults, the charity must continue making the payments. This insurer default risk is nearly non-existent however, as my research has not shown one immediate annuity that was in payout stage (that is, making current annuity payments rather than a deferred annuity) has ever defaulted in American history. Life insurance companies have gone bankrupt, of course, though other life insurance companies typically purchase their assets and liabilities, or state guarantee funds are available to some statutory limits. Policy owners receiving current benefits have historically received a higher degree of protection than those with deferred benefits (*e.g.*, life insurance policies or deferred annuities).

Even with this risk being minimal, a charity should still employ a prudent purchasing strategy to select the most financially strong insurers possible as evidenced by high safety ratings.

3. Doesn't reinsurance cost too much? And, shouldn't there be a high correlation between the charitable income tax deduction and what remains after the reinsurance premium is paid?

If a charity wants to reinsure 100% of the liability, the cost or premium required ranges between 45% (for a 90 year-old male) and 75% (for a 65 year-old female). Most people still have a difficult time grasping the American Council on Gift Annuity actuarial assumptions, which are:

1. assume every donor is a female and is 18 months younger than their actual age,
2. a 6% gross or 5% net constant investment return, and
3. an average 50% remainder to charity.

The key time value of money concept to understand in this analysis is that the 50% average remainder to charity is a future value — i.e.: the 50% remainder will be received in the future at the death of the donor.

Often I hear, "Why would we give an insurance company 70% of the gift, leaving our charity only 30%, when we are supposed to receive 50%?" The 30% is present value (or money today) and the 50%, of course, is future value (or money at the donor's expected death). To make this overly simplistic analysis a little closer to apples-to-apples, how would the charity invest the money to the donor's life expectancy knowing they won't have to make any payments? The straight-line constant or Monte Carlo analysis then becomes, which number projects a higher ending balance at the donor's life expectancy? In our research, we found the reinsured "side-account" was larger than the "self-insured" account 75-85% of the time, and was greater in 100% of the scenarios where the "side-account" earned 1.75-2% more than the "self-insured" account. Said simply, the smaller, initial value after reinsurance caught and passed the traditional "self-insured" account between 2-5 years prior to life expectancy.[2]

Also, I hear, "If the donor's income tax deduction is $100,000 which we assume to be the accurate present value of the charitable gift, then why do we only have $80,000 left over after the reinsurance premium? Is that extra $20,000 the insurance company's profit?"

There are a number of ways to determine the present value of a gift, only one of which is the charitable income tax deduction methodology. The summarized calculation is to discount the life-income interest to present value using the current applicable federal rate (AFR) and the 1990 unisex census table, and then simply subtract that amount by the original gift.

Simply by substituting the ACGA-assumed life expectancy table for the 1990 life expectancy table, the present value of the charitable gift generally is reduced by 15-25% because of the longer life expectancy.

The life insurance company will use an internal life expectancy table for annuitants and discount rate, and therefore will derive a different present value of the liability.

4. What donor, gift and charity characteristics make reinsurance attractive or unattractive?

The donor and gift characteristics that make reinsurance the most attractive are:

- older donors
- healthy donors
- immediate annuity payments
- female donors
- large gifts relative to the pool
- donor's who wish to see the money work immediately
- restricted gifts (such as those governed by fund agreement)

The converse of these characteristics make reinsurance generally less attractive.

The charity's characteristics that make reinsurance the most attractive are:

- new or smaller pools
- large concentrated gift into existing pool
- the charity's desire to use some money immediately
- the charity desires the least amount of administration possible
- the charity is organizationally risk averse
- financial modeling that projects higher ending balances under reinsurance vs. self-insurance
- there is no excess reserves or unrestricted money to draw upon if a CGA exhausts (*i.e.*, go negative).

The converse of these characteristics make reinsurance generally less attractive.

From a risk standpoint, our research shows that donors older than 75 have more longevity risk than investment risk. The riskiest CGA, by far, is a 90-year-old single female with a disproportionately large gift annuity. The least risky CGA, is a 20-year deferred CGA on a 45-year-old male.

The decision to purchase reinsurance is an irrevocable decision that should not be taken lightly, so it is important to review these various characteristics.

5. What kind of insurance products are used for reinsurance, who sells them and what are the expenses?

In the vast majority of cases, the ideal product is a life-only single premium immediate annuity or a group retirement income immediate annuity (charities might also consider purchasing a life and period certain on a case-by-case basis as well). The former is more of a retail product and the latter may only be sold to corporations (including non-profits) and is generally used in the pension plan arena. Interestingly, the contractual annuity obligation that a corporation has to a retired employee - *e.g.*, guarantee 50% of income for life, is exactly the same contractual obligation a charity has to a gift annuitant.

Generally, just about any properly-licensed life insurance agent can sell retail annuities and most all annuity brokers can sell either the retail annuities or group retirement income annuities.

Many of the most competitive and highly-rated annuity companies only offer commissioned products which usually range from 3.5 to 4.5% with the agent receiving about 65 to 75% of the commission. There are two or three highly-rated carriers offering non-commissioned products as well. For the most competitive companies, pricing may change as often as every 48 hours and firm quotes will usually require a target funding date and the companies may hold the quote as long as 10 days.

6. How do life insurance companies handle investment and longevity risks and how do they derive a profit?

Life insurance companies manage investment and longevity risks in the following ways:

- they enjoy the law of large numbers in their annuity pools, helping to more accurately predict life expectancy,
- they perfectly match assets to liabilities and have virtually zero equity exposure,
- they usually limit individual annuities to $1 million per person and will actually decreasing pricing for higher amounts or decline to issue an annuity altogether,
- they have negatively correlated life insurance pools to offset the annuity pools (if people in the aggregate live longer than expected, their life insurance business is more profitable; if they die sooner than expected, their annuity business is more profitable).

Insurance companies will invest annuity premiums in fixed income buckets to match the life expectancy of the donor. For example, an annuity premium for a 77-year-old donor is invested in a 15-year fixed income tranche[3] at 6.25% - the internal rate of return might be 5.0-5.3%. The insurance company's profit is the spread between their earned rate (6.25%) and the credited rate (5-5.3%) and usually amounts to an 8-12% present value profit for the company. From a risk perspective, this is the opposite of a typical investment manager fee structure of .75-1.25% annually on the asset value in that the investment manager is not bearing the risk of market performance as the crediting rate is not guaranteed, yet the present value profit margin is nearly identical.

All other annuity expenses like marketing, administration, etc., simply lower the net internal rate of return to the company.

7. How should a charity develop policies and a financial model for determining if reinsurance is appropriate?

Charities should develop charitable gift annuity risk management policies that answer the following questions:

- Up to what level will we self-insure CGAs?
- When will we try to reduce risk and how strategies will we employ?
- At what level will we consider reinsuring a part of the gift?
- At what level will we cross our maximum threshold and reinsure 100% of the gift?

Clearly, every charity will have different answers to each of these questions, but it is important to view charitable gift annuity gift acceptance beyond minimum ages and minimum gift sizes.

From a purely financial point of view, the optimal reinsurance level for most gifts is to simply use the allocation dedicated to fixed income for the annuity premium. Basically, the internal rate of return within an immediate annuity plus the inherent longevity hedge will produce a greater remainder at life expectancy in nearly every scenario. This is true so long as dollars are not "cannibalized" from the equity allocation (assuming equities are projected to have a higher net expected return than the immediate annuity).[4]

What follows is an analysis for a 77-year-old female and a $100,000 charitable gift annuity. The pink line represents the fully reinsured balance over time and the blue line represents self-insured balance. Note that the A, B, C and D markers represent ending balances under four different life expectancy tables.

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The internal rate of return calculations can be seen in the table below:

Life Expectancy Table	IRR for Annuity
IRS Charitable Deduction Table (Uni-Sex 1990 Census Table)	4.81%
Annuity 2000 Table	5.04%
ACGA-Assumption Used to Calculate Recommended Rates	5.21%
Behan/Clontz CGA Mortality Table	5.53%

Note: the Behan/Clontz CGA Mortality table was developed for the Society of Actuaries in 2005 and can be seen at http://www.soa.org/ccm/content/areas-of-practice/life-insurance/research/mortality-of-beneficiaries-of-charitable-gift-annuities/

8. Can a gift annuity pool or individual annuity be partially reinsured, and if so, how does a charity determine how much should be reinsured? And can be reinsurance be used with "under-water" annuity?

As has been stated, partial reinsurance tends to work quite well on an individual annuity or pool, if used as a fixed income alternative investment unless the specific annuity is over the maximum retention threshold. Also, it is very common to select specific gift annuities within a pool to reinsure while self-insuring the remaining CGAs.

Reinsurance can be especially effective for "under-water" annuities — those that have a reserve balance (asset) less than the present value of the liability or required immediate annuity premium (liability). In these situations, an optimal asset allocation of stocks/bonds/reinsurance can be designed to solve for the asset allocation that produces the

lowest exhaustion ratio (the same as to solve for the mix necessary to produce the payments for the longest period of time).

9. How does reinsurance effect our state reserve compliance, FASB compliance and internal administration?

Most states allow a reserve reduction for the annuities that have been reinsured subject to certain state-specific requirements.[5] It is important to design the product to meet the specific guidelines of IRC 170(f)(10) as well.

For FASB purposes on life-only annuity contracts, an annual present value of the liability calculation is all that is required as that number will perfectly match the asset value of the annuity contract.

For internal administration, it is prudent to have annuity payments made directly to the charity so the donor actually receives a check directly from the charity pursuant to the annuity contract.

Important Note: The life insurance company will mail 1099s to the charity that will be completely wrong. Do not send these 1099s to the donor under any circumstances. Instead, generate the gift annuity specific 1099s and mail them to your donors.

10. What impact does reinsurance have on the donor from a tax perspective and a prudent disclosure perspective?

The donor's tax situation should have no impact so long as reinsurance is not required by the charity (see Rev. Rul. 62-137, 1962-2 C.B. 28).[6] In this rare case, the donor's income tax deduction is simply:

Funding Asset - Reinsurance Premium = Charitable Income Tax Deduction

Since it is not wise to make reinsurance a policy for all gift annuities, nor is it wise to reference it directly in the original contract, the donor's income tax deduction is rarely affected.

From a disclosure perspective, it is excellent practice to include the reinsurance option within the charity's disclosure letter as well as discussing the option with the specific donors before reinsurance is purchased. The donor may mention a health problem or some other compelling reason not to reinsure, but at a minimum, it is good donor stewardship to disclose reinsurance so that there are no future surprises with the donor(s) or his/her heirs. Having said this, it is very important to educate the donor as to why the charity might choose this risk management method and that prudent gift annuity stewardship may outweigh the donor's wishes.

Summary

This article is not meant to capture every reinsurance question nor to even exhaustively answer the top 10 questions. The purpose is to provide for-profit and non-profit gift planners with a CGA reinsurance primer so that they can both better understand the subject and to see where reinsurance has beneficial applications.

Footnotes

[1] For a deeper discussion of state-specific definitions and requirements, see Clontz, B. and Behan, D., "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." Journal of Gift Planning, 2nd Quarter, 2005.

[2] See Newton, M. and Clontz, B., "An Analysis of Commercial Insurance as an Alternative Gift Annuity Financing Option." Journal of Gift Planning, 4th Quarter, 1998.

[3] A "tranche" can best be defined as a fixed income bucket defined by a specific time period or maturity. For example, a block of 10-year mortgages, 10-year corporate bonds and 10-year Treasuries, would constitute a 10-year fixed income asset tranche which might be designed to match or off-set a 10-year liability.

[4] See Clontz, B. and Behan, D., "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." Journal of Gift Planning, 2nd Quarter, 2005.

[5] See Clontz, B. and Behan, D., "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." Journal of Gift Planning, 2nd Quarter, 2005.

[6] There is an excellent discussion of this topic in "Big Hat — No Cattle? Repositioning Your Gift Annuity Program" by Tom Cullinan and Phil Karno. Presentation paper for the 2004 National Conference on Planned Giving.

4 Comments Add Your Comment

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-- Mark Absher on 3/30/06 3:29 PM

I note that reinsurance as outlined in this article technically serves only to assist the charity in the financing of its obligations. It does nothing to secure or "reinsure" the charitable gift annuity from the perspective of the donor. If a charity with 100% reinsured annuities were to become insolvent, the donor has no specific claim to the "reinsurance" annuity and remains only a general creditor of the charity.

I am aware of one solution to provide the donor with the appropriate level of security.

Response to Mark

-- Bryan Clontz on 3/30/06 3:48 PM

In theory, you are correct, however, in practice the donors are usually protected in the event of a defaulting charity. I served as an expert witness on just such a situation and the judge partitioned off the reinsured annuities so that they were not subject to the claims of creditors.

More specifically, I recommend designing the annuity contract to specifically provide for a charitable bankruptcy. In this case, the charity as owner directs the insurance company to cease making payments directly to the charity and to make the payments directly to the donors. In fact, California and Wisconsin specifically require this provision as part of consumer/donor protection and I think it does no harm to include it for all states.

Your question was one that I have always been curious about, but fortunately, throught the courts or the contracts, it seems to be a non-issue.

Bryan Clontz

CGA Re-Insurance

-- Fred Kelner on 3/30/06 6:42 PM

Are there income tax implications when the insurance company makes payments directly to a donor upon a charity's insolvency?

Response to Fred

-- Bryan Clontz on 3/30/06 7:38 PM

I will defer to the tax experts on this question, however the taxation shouldn't change in my view. First, some charities ask the insurance companies to pay the donors directly for administrative convenience (something I do not recommend). As owner of the contract, they have the right to select the payee. Second, in the event of insolvency, the charity remains the owner of the annuity contract, however the payee will contractually default to the donor. The essence of a gift annuity contract - lifetime payments to a donor in exchange for a donation - remains intact.

Thankfully, this situation has only occured once in history to my knowledge. And that was not exactly a normal situation as the founder was sentenced to 10 years in prison for taking nearly $44 million of donor contributions.

Hope that is helpful.