BNY MELLON
WEALTH MANAGEMENT

Increasing Payout Rates for Charitable Gift Annuities

By Lindsey A. Glode, CFA
Investment Officer

David Hohler
Director of Investments,
Planned Giving

In April 2018, the American Council on Gift Annuities (ACGA) announced it would raise its suggested maximum payout rates on gift annuities, effective July 1, 2018. This is the first rate change since January 2012, and the first rate increase since July 2011. After six years of all-time low payout rates, gift annuity issuers are assessing how the new rates will impact their charitable gift annuity programs. Central to the rate change is the increase in the ACGA's rate-of-return assumption from 4.25% to 4.75%.

At the same time, after nine years of consistently positive equity returns, elevated equity valuations, increasing volatility and rising interest rates, many market participants, including BNY Mellon, are reducing expectations for future returns. All else being equal, increasing the payout rate or reducing the assumed rate of return on an annuity decreases the dollar amount that a charity receives at the termination of the gift, commonly referred to as the residuum amount.

Since 2009, charities have been able to take advantage of low payout rates and higher investment returns to realize higher annuity-residuum amounts. Is this rate increase occurring at exactly the wrong time? Will annuity residuum amounts decline in the years to come? Will the increase in payout rates increase gift volume? What can annuity issuers do now to ensure a financially viable gift annuity program in the future? In our review of this important issue, we answer some basic questions about the rate change, review the historical context of payout rates, analyze the potential impact on residuum amounts, and provide insights on best practices for gift annuity issuers.

How Significant Is the Rate Change?

The ACGA's published rate tables provide the suggested maximum payout rate for a specific annuity based upon the age of the beneficiary at the time the gift is written. For a single life annuity, the new suggested rates have increased between +0.3% and +0.5%, with the largest increases for beneficiaries aged 79 years and above. For joint or dual life annuities, suggested rates vary depending on the age of both beneficiaries. For example, rates at the youngest end of the spectrum (5 year old and 5-95+) suggested payout rates increased 1%. At the other end of the spectrum (95 year old and 95+), suggested rates increased 0.5%, with varying degrees in between. The table below summarizes the rate changes for single life annuities, effective July 1, 2018.

Exhibit 1. Rate Changes for Single Life Annuities

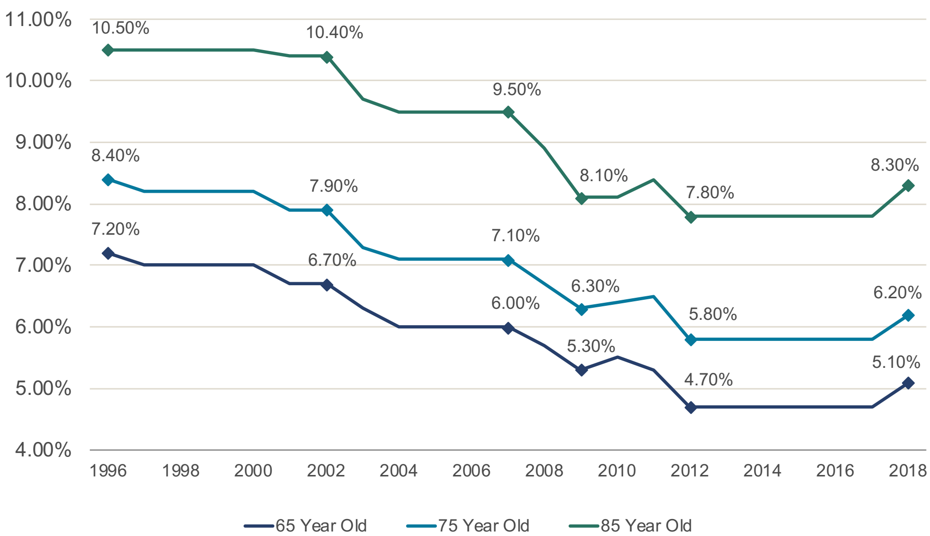
Age	New Rate	Old Rate	Change
45–47	3.8%	3.5%	0.3%
50–51	4.0%	3.7%	
57	4.4%	4.1%	
62	4.8%	4.5%	
66	5.2%	4.8%	0.4%
72	5.8%	5.4%	
75	6.2%	5.8%	
79	7.1%	6.6%	0.5%
85	8.3%	7.8%	
88	8.9%	8.4%	

Source: "Suggested Maximum Charitable Gift Annuity Rates (Effective July 1, 2018)." American Council on Gift Annuities.

In order to better understand the magnitude of these changes, it is helpful to evaluate them in a historical context. Beginning in 2002, the ACGA suggested rates decreased significantly from the elevated payout rates of the 1990s. In the period prior to 2002, the suggested payout rates reflected very optimistic expected return assumptions that were very favorable to annuitants. The tech bubble of the early 2000s and Great Recession of 2008-2009 led to significant and lasting decreases to the suggested payout rates as charities struggled to adjust to a lower-return environment.

In response to the financial hardships faced by many gift annuity issuers, the ACGA reduced payouts aggressively beginning in 2008; by 2012, suggested payout rates reached all-time lows. For example, the payout rate for a 75-year-old single life annuity went from 8.4% in 1996 to 5.8% in 2012, a decrease of over 30%. In an effort to help charities recover from the investment losses suffered in the 2000s, the ACGA-suggested rates remained at or near all-time lows for over nine years. Viewing the current recommended payout rates relative to historic rates shows that the changes effective July 1, 2018, while significant, still leave rates well below those in effect prior to 2008.

Exhibit 2. ACGA Suggested Maximum CGA Rates: Single Life



Source: "Explanation of the ACGA Gift Annuity Rates April 2018." American Council on Gift Annuities.

What Assumptions and Methodology Does the ACGA Use to Set Payout Rates?

The ACGA reviews market conditions and recommends payout rates to sponsors and gift annuity issuers on an annual basis. The ACGA's suggested payout rate methodology is based on the following five assumptions:

1. **Target residuum**: 50% of original gift value
2. **Mortality**: 2012 Individual Annuity Reserving Table (2012 IAR), 50% male/50% female blend
3. **Expenses**: 1% annual administrative expenses
4. **Investment returns**: 4.75% annual expected return
5. **Payment frequency**: Quarterly at end of period

There is a direct relationship between the annual expected return and recommended payout rates; the higher the expected rate of return, the higher the payout rate. The expected annual return is based on a model asset allocation consisting of:

Equities: 40% allocation, 8% annual return, based on historic annualized return of S&P 500 index for the period 1926 to 2017 (approximately 10%), less a 2% conservatism discount.

Fixed income: 55% allocation, approximately 2.5%, based on average current yield using a 13-week rolling average on the 10-year U.S. Treasury bond.

Cash: 5% allocation, approximately 1.5%, based on average current yield using a 13-week rolling average on the three-month U.S. Treasury bill.

It is important to note that all of the ACGA return assumptions are based on historic returns or yields rather than more subjective estimates of future returns, yields or economic forecasts. In addition, the ACGA model portfolio seeks to limit downside risk and volatility of returns by more heavily weighting fixed income versus equities.

The ACGA believes that its allocation is "achievable by virtually all charities,"[1] however, under certain circumstances, actual gift annuity portfolios may be invested differently to meet the goals and objectives of a particular charitable organization.

Why Did the ACGA Raise Recommended Payout Rates?

Understanding the methodology behind rate setting and the history of residuum amounts gives us some clues as to why the ACGA decided to change rates now.

First, the mechanics behind the expected return calculation support the case for increasing rates. The largest component of the ACGA expected return calculation is based on the 10-year Treasury bond yield, which, as of April 2018, had increased significantly over the past year. The increase in yield led to an increased expected rate of return for fixed income in the ACGA model, which results in a higher overall expected rate of return. With the 50% residuum objective unchanged, higher expected investment returns allow more room for higher gift annuity payout rates.

[1] "Explanation of the ACGA Gift Annuity Rates April 2018," American Council on Gift Annuities.

We can also deduce that since there were no rate increases in the environment of economic growth and strong investment returns since 2011, the ACGA has been cautious in order to help annuity issuers recover from losses suffered in 2008-2009. In fact, residuum amounts have remained well above the 50% objective despite the impact of the Great Recession.

According to the ACGA's most recent Survey of Charitable Gift Annuities, annuity issuers have consistently reported residuum amounts well in excess of the 50% objective. In the 2017 survey, the average residuum amount was 62% of the original gift value, a slight decrease from the 2013 survey. According to the 2018 BNY Mellon Charitable Gift Report, which details gift activity for BNY Mellon planned giving clients, gift annuity residuum amounts remained above 90%. We believe that the high residuum amounts were also a consideration in the ACGA's decision to increase payout rates in 2018.

ACGA Investment Return Assumptions vs. BNY Mellon CAPM Assumptions

On an annual basis, BNY Mellon Wealth Management develops capital market assumptions for approximately 50 asset classes worldwide. The assumptions are based on a 10-year time horizon and are the basis for long-term asset allocation decisions. In the 2018 update, BNY Mellon broadly reduced its capital market assumptions, citing several economic and demographic headwinds. As a result, the expected return of a 50% equity and 50% fixed income asset allocation decreased from 5.01% to 4.82%.

At the same time, the ACGA increased its investment return expectation to 4.75% from 4.25%. The two models for expected returns are moving in opposite directions at exactly the same time. Is this a coincidence, the result of inconsistencies in methodology, or an expression of differing views on the state of the economy and financial markets? Once again, a clear understanding of the methodology for each model will help answer these questions. As we previously highlighted, the ACGA assumptions are based upon historic returns or yields, while BNY Mellon assumptions are based on subjective long-term economic or financial forecasts. Therefore, in today's rising interest rate environment, typical of the latter stage of the economic cycle, the ACGA and BNY Mellon assumptions are, in fact, more consistent than they appear. Despite the differences in methodology and assumptions, the difference in expected returns between the ACGA and BNY Mellon is only 0.07%.

What Impact Will the Rate Change Have on Residuum Amounts?

Gift annuity issuers may be concerned about the impact to residuum amounts of increasing payout rates. While it is impossible to predict future residuum amounts, we can use statistical techniques to estimate the impact of increasing payout rates. We ran a simulation in combination with BNY Mellon's 10-year capital market assumptions to estimate how expected residuum amounts may change under the new ACGA recommended rates.

For a charitable gift annuity established by a75-year-old donor, a charity may now expect to realize a 52% residuum, down from 61% previously. While the projected residuum amount decreases regardless of age, we would note that on the whole they more closely approximate the ACGA target residuum of 50%. The table below shows a summary of the results of the simulations.

Exhibit 3. Old Rates vs. New Rates

		Old Rates		New Rates	
AGE		Payout %	Residuum	Payout %	Residuum
	Top Quartile (75%)		138%		115%
65	**Expected Case (50%)**	**4.70%**	**79%**	**5.10%**	**59%**
	Bottom Quartile (25%)		38%		14%
	Top Quartile (75%)		93%		86%
75	**Expected Case (50%)**	**5.80%**	**61%**	**6.20%**	**52%**
	Bottom Quartile (25%)		33%		28%
	Top Quartile (75%)		80%		70%
80	**Expected Case (50%)**	**6.80%**	**55%**	**7.30%**	**46%**
	Bottom Quartile (25%)		36%		29%
	Top Quartile (75%)		72%		67%
85	**Expected Case (50%)**	**7.80%**	**53%**	**8.30%**	**48%**
	Bottom Quartile (25%)		39%		32%

Assumptions: (1) "New Rates": July 1, 2018 ACGA Rate Tables. (2) "Old Rates": January 1, 2012 ACGA Rate Tables. (3) 2012 IAR mortality table. (4) Female, single-life annuity. (5) Life expectancy rounded higher to whole integer. (6) Annual, end of year distributions. (7) BNY Mellon Wealth Management 10-Year Capital Market Assumptions. (8) Balanced Asset Allocation (50% Equity, 50% Fixed income).

What Are Some Other Factors That Gift Annuity Issuers Should Keep in Mind?

First, the recommended payout rates are going into effect for new gifts only — new means new. The residuum amounts for annuities issued today will not be known for 10 years or more. The impact on residuum amounts experienced by gift annuity issuers will be gradual over the next several years. We expect that organizations that issued annuities over the last 10 years, despite the challenges resulting from 2008-2009, will likely benefit from this period of all-time low payout rates. In fact, we see evidence in the 2018 BNY Mellon Charitable Gift Report that residuum amounts for gifts made after 2009 are consistently in excess of the 50% residuum objective. We have not yet begun to realize the residuum amounts for the majority of annuities issued since 2009. The good fortune of low payout rates and strong returns will cushion the potential impact of today's rate increase on residuum amounts for many years to come.

Second, gift annuities continue to be an attractive means for donors to fulfill their philanthropic, tax planning and estate planning goals. Increasing the payout rate may entice new or existing donors to make new gifts, effectively making up for expected lower residuum amounts with a higher volume of gifts. An additional benefit of higher gift volume is the diversification of risk for annuity issuers. Diversification across lives and time helps to mitigate longevity risk and market risk, and generally results in a financially sustainable gift annuity program. In the end, the benefits to gift annuity programs from a risk perspective may outweigh the potential reduction in residuum amounts for new annuities.

Will Charities Adopt the Rate Increase?

In a word, yes. ACGA member organizations that follow the recommended annuity rates have consistently been over 95%. In 2017, the adoption rate was 97% of respondents to the ACGA Survey of Charitable Gift Annuities. By far, the benefits of following the ACGA recommended rates outweigh the costs. The ACGA recommended rates are recognized by all applicable state regulatory agencies as the standard for annuity issuers. The methodology for determining rates is transparent and based on industry-standard techniques and principles. For gift annuity issuers, not following the ACGA recommended rates can lead to additional filing requirements or reporting in many states, and may require additional actuarial analysis to maintain compliance. For this reason alone, we strongly recommend that annuity issuers follow the ACGA recommended rates.

Where Do We Go From Here?

After nine years of all-time low payout rates and strong investment returns, and faced with the uncertainty of today's economic environment, it is natural for gift annuity issuers to assess the ramifications of the ACGA's payout rate increase on their organizations. In all likelihood, increasing the payout rate for gift annuities will reduce residuum amounts for new annuities. However, we believe that charitable institutions with active, healthy gift annuity pools and appropriate gift-acceptance and asset allocation policies can continue to expect at least a 50% residuum on annuities written today with the new recommended ACGA rates.

About the Authors

Lindsey A. Glode, CFA
Investment Officer

Lindsey is an Investment Officer for BNY Mellon Wealth Management's Charitable Solutions Group. In this role, she works directly with non-profit clients to address their investment management needs. Lindsey joined the firm in January of 2017.

Prior to that, Lindsey spent seven years at Langen McAlenney, a division of Janney Montgomery Scott, in Hartford, CT as a sell-side equity research analyst. In this role, she was responsible for research, analysis, and recommendations of publicly traded insurance companies. Lindsey also completed an MBA internship at State Street Global Advisors, in the Investment Solutions Group, where she was challenged with creating hedge fund replication strategies to capture alternative/exotic beta.

Lindsey received a Master's degree in Business Administration from Boston College and a Bachelor's degree from Fordham University. She is a CFA charterholder and a member of the CFA Society Boston.

David Hohler
Director of Investments, Planned Giving

David is the Director of Investments for BNY Mellon Wealth Management's Planned Giving Group. In this role, he is responsible for overseeing the team of investment professionals that manage planned giving assets. David also works directly with clients to design, implement, and actively-manage their planned giving portfolios. His clients include secondary schools, healthcare groups, colleges and universities, religious and cultural organizations and community foundations.

David joined the firm in 2006. Prior to that, David worked at Frank Russell & Co. in Tacoma, WA. While at Russell, David served as manager of portfolio trading operations. In this role, he supervised the team responsible for the data management, cash flow monitoring, reconciliation, portfolio accounting and performance measurement of derivatives-based overlay and hedge strategies.

David received a bachelor's degree with a major in economics from the University of Delaware and a master's degree of business administration from Seattle University. David is a CFA Charterholder and a member of the CFA Society Boston.