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WEALTH MANAGEMENT

Protecting Your Gift Annuity Program From “Underwater” Gifts

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Charitable gift annuities are one of the most popular planned giving vehicles and a hallmark of many of today’s most successful programs. They provide a simple, tax-efficient means for donors to support causes and organizations that they are passionate about. Unfortunately, not all gift annuities are able to fulfill the donor’s charitable intent. A 2017 review of gift annuity programs conducted by BNY Mellon Wealth Management found that nearly 50% of issuing organizations had at least one gift annuity that was “underwater” — that is, where the gift assets were exhausted before the death of the final income beneficiary. Over 90% of organizations had at least one gift projected to be underwater before its expected termination date, based on current mortality assumptions.

Underwater gift annuities are common for charities of all types and sizes. In our experience, it is almost certain that a charity issuing gift annuities will have an underwater gift at some time. Effective identification and management of current underwater gifts — and gifts that are projected to go underwater — is vital for charities to manage the financial risks inherent with issuing gift annuities, to protect their reputations as responsible stewards and to cultivate future gifts from their donors.

The Risks of Underwater Gift Annuities

The expected outcome for a gift annuity is the fulfillment of the donor’s charitable intent by contributing 50% of the original gift value to the charity at termination. In some cases the residuum is higher than 50% and sometimes it is lower than 50%, but in most cases, at least some gift assets are left to benefit the charity.

When a gift annuity goes underwater, it exerts financial pressure on the charity, as the distributions made each payment cycle drag the value of the gift assets down further and further. Eventually, this may require the charity to cover the beneficiary distributions with other funds from outside the gift annuity pool, reducing the charity’s ability to support its mission-related activities. The erosion of gift assets can also pose regulatory risk for charities that issue annuities in states that require minimum reserve levels.

Additionally, the failure to fulfill a donor’s charitable intent can damage a charity’s reputation among its donors. The reputational risk associated with a single underwater gift may be even higher than the financial risks, due to the potential loss of future gifts and the erosion of donor confidence.

What Causes Gift Annuities to Go Underwater?

The four most common reasons for a gift annuity to go underwater are:

- Inadequate gift structure and acceptance policies
- Donor longevity
- Low investment returns
- Funding asset illiquidity or insolvency

It is important for a charity to understand these causes in order to make informed decisions and implement measures to mitigate the risks that are within their control.

Inadequate Gift Structure and Acceptance Policies

The most important factor in determining the success or failure of a charitable gift annuity is the application of a disciplined gift-acceptance policy. The competition for donors and the ever-growing fundraising goals many charities face make it tempting to offer annuity terms that are perhaps too attractive to donors. Accepting unusually large gifts, offering higher payout rates than the American Council on Gift Annuities (ACGA) recommends, withholding some of the charitable portion of the gift for current spending or marketing immediate annuities to young donors can boost fundraising numbers but may ultimately hurt the programs they are meant to serve. The consistent application of a sound gift-acceptance policy by a charity can prevent well-intentioned but risky decisions that lead to underwater gift annuities.

Gift-Acceptance Policy Best Practices

- Adhere to ACGA-recommended payout rates
- Establish a prudent minimum beneficiary age
- Establish a maximum gift amount or a review process for large gifts
- Fully fund the annuity pool with gift assets
- Develop guidelines for accepting illiquid or hard-to-value assets

Longevity

Life expectancy plays a major role in the determination of the gift annuity rate, yet it is far from precise. In fact, there is a good chance that a donor will outlive their life expectancy and your organization will be obliged to make annuity payments longer than expected. The risk of the annuitant outliving their actuarially determined life is known as longevity risk. The ACGA has implemented several measures in its rate-setting methodology to address longevity risk. It uses the latest gender-biased mortality table (2012-IAR) and assumes that all annuitants are female and one year younger than their actual age.

Some charities employ additional measures, like setting a minimum age requirement in their gift-acceptance policies. All of these measures, while prudent, cannot eliminate the longevity risk faced by a charity that issues annuities.

Low Investment Returns

Investors cannot control the timing, magnitude or duration of market returns. As a result, there is an inherent risk that the rate of return gift assets are able to earn will be too low to sustain the annuity payments over the donor's life. When gift annuity investments perform poorly, there is a significant impact on the market value of the gift. For example, if the investments decline by 10% and the annuity payout is 6%, the market value of the gift will decrease by a total of 16%. In order for the assets to recover to the initial funding level after funding the annuity payments in the following year, they would have to earn almost 26%.

This situation is most problematic for new gifts or gifts with long remaining lives. If the annuity assets experience negative returns early on, the effective payout rate grows, making it impossible for the assets to recover. The effective payout is the dollar payout expressed as a percentage of the current market value of the gift assets. The effective payout rate increases as the market value of the gift assets declines. If the annuity assets experience a prolonged period of low or negative returns, or a severe drawdown like those that occurred in 2000 or 2008, the likelihood that the annuity will go underwater increases dramatically. Prudent investment management and diversification through asset allocation can reduce, but not eliminate, market risk for any single annuity.

Funding Asset Illiquidity or Insolvency

Accepting assets that cannot be sold in a timely manner or that are not easily valued can be very risky. For example, a gift of real estate may not be able to be sold for many months or years after the gift date. In the meantime, the charity is obligated to make annuity payments, which must come from other sources. Furthermore, the sale price may be quite different than the appraised value of the property used to establish the annuity distributions. If the sale price is significantly lower than the appraised value, the probability of the gift annuity going underwater increases due to a higher effective payout. A charity should use caution and seek expert advice, such as a qualified appraisal, when accepting gifts of any asset other than cash or marketable securities.

Identifying At-Risk Gift Annuities

Diligent oversight and administration are the keys to managing a successful gift annuity program. Periodic review of the health of the gift annuity pool, including the review of each underlying gift, is the best way to spot potential trouble. In our paper, "Understanding Key Metrics for a Healthy Charitable Gift Annuity Pool," we provide a list of key metrics to assist with this process.

The most important techniques for identifying gifts that may go underwater involve analyzing the "Projected Years to Exhaustion" for each gift. Comparing the gift years remaining to the projected exhaustion at various levels of expected return can identify potential underwater gifts many years before the assets are exhausted. Early identification and ongoing monitoring provide a charity with the time and information needed to make decisions about how to proceed.

Finding Funding for Underwater Gift Annuities

Over the years, BNY Mellon has helped many clients assess and manage underwater gift annuities. Underwater gifts, if identified and managed, do not necessarily spell disaster for a charitable gift annuity program. Ultimately, a charity must determine when, by what means and for how long annuity payments for underwater gifts will be funded.

Annuity Pool Assets

When a charity has a large surplus in its annuity pool, it can be used to fund payments. As the payments are made, the surplus of the annuity pool declines and the market value of all of the other gifts in the pool subsidizes the underwater gifts. Over time, this reduces the residual value of the other gifts in the pool and the benefit to the charity. The cost of the underwater gifts is spread across all of the other annuities and is realized as those gifts mature over time. This can be problematic for annuity programs that have a large percentage of specifically designated gifts. Gift agreements, contractual obligations and donor considerations may limit a charity's ability or willingness to use other annuity assets as a funding source.

Retain Terminations

Gift annuity assets are the property of the charity. Therefore, the residual assets of unrestricted or undesignated annuities that mature can be retained in the annuity pool. By foregoing the residuum on terminated gifts, the charity can offset the payments on underwater gifts without using the charity's other operating funds.

Unrestricted or Operating Funds

The charity can use other unrestricted or operating funds to make payments for the underwater gift annuity. This prevents the gift annuity from going further underwater and isolates the impact to the other gifts in the pool, but diverts resources that could be used for current mission-related activities.

Ask the Donor to Relinquish Income Interest

Some donors may be willing to relinquish their income interest in the annuity if they learn that the annuity obligation is harming the charity. Informing a donor that their charitable intent will not be fulfilled is always a difficult one. However, it can also be an opportunity to reaffirm credibility with the donor and to protect the charity's reputation. In some cases, it can even lead to additional gifts or other commitments from the donor. If the annuity contract allows for the income beneficiary to relinquish their income interest, the charity may consider this option.

Early Identification Is Critical

The vast majority of gift annuities are successful in fulfilling the donor's charitable intent. According to the 2017 BNY Mellon Wealth Management Annual Charitable Gift Report, gift annuity residuum amounts have been between 80% and 90% of original gift value over the last four years. However, many charitable organizations will likely have to deal with an underwater gift annuity at some point.

Prudent management, administration and oversight of a gift annuity program will not guarantee that all gifts will be successful. Gift annuities can and do go underwater, causing real problems for issuing charities. If not identified early and managed properly, underwater gifts can put financial strain on the annuity pool, erode residual values, cause regulatory compliance issues and detract from a charity's reputation with its donors.

Understanding what causes gift annuities to go underwater, the oversight techniques that can identify them early and measures that can be taken to mitigate their impact are essential to ensuring the long-term health of the charity.

About the Authors

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David Hohler is a senior investment officer for BNY Mellon Wealth Management's Charitable Solutions Group with over 15 years of investment management experience. David works directly with charitable clients to design, implement and monitor their investment portfolios, along with advising on asset allocation, investment policy, manager selection, and performance evaluation.

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.

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Prior to joining BNY Mellon, John spent nearly 15 years in the Securities Lending division at Brown Brothers Harriman & Co. John worked closely with institutional investors to create and execute customized strategies to maximize revenue, and maintained relationships with the prime brokerage community with whom he negotiated terms of securities loans. Ultimately, John served as the lead EMEA and APAC trader on BBH's Boston trading desk.

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