Charitable gift annuities come full circle with reinsurance

John Trumbull, an American artist during the American Revolutionary War, is credited with the creation of the first modern charitable gift annuity (CGA) when, in 1831 he sold a series of 28 paintings and 60 miniature portraits to Yale University in exchange for a $1,000 annuity. In creating CGAs, Trumbull and his attorney Peter Augustus Jay adapted “complex ideas and methods from life insurance, pension, and banking companies for [a] new, charitable purpose.”¹ Today, philanthropic organizations have turned to insurance companies — from whom the idea for CGAs was first derived — to help manage their obligations with CGA reinsurance.

For some nonprofit organizations that want to decrease the risks involved with all or a portion of their gift annuities, reinsurance may make sense. When you reinsure, you purchase protection from a life insurance company to cover your organization’s annuity payment obligation using a portion of the initial gift. In exchange, the insurance company agrees to make payments either to the charity or directly to the annuitants.² It also transfers most of the administrative duties of a CGA program to the insurance company so the organization can refocus its resources on the charity’s mission.

**CGA basics**

CGAs enable donors to support causes they care about, while gaining the security of lifetime income for themselves and, oftentimes, for their spouses or other loved ones. With a CGA, which involves a contract between a donor and a charity, the donor transfers cash or property to the charity in exchange for a partial tax deduction and an annuity that provides a guaranteed stream of income from the charity. The amount of the income stream is determined by many factors, including the donor’s age and the policies of the charity. Most charities in the United States use payout rates defined by the American Council on Gift Annuities (ACGA). A CGA donor can typically begin to receive income right away, or at a predetermined date in the future, the latter of which can be attractive for younger donors. CGAs are particularly well-suited for philanthropic, often high-net-worth retirees, to meet their need for lifetime income and a desire to donate money to charity in a tax-advantaged way. When the contract ends and the donor (or their survivor in the case of a joint and survivor annuity) dies, the charity keeps the remaining portion of the gift — known as a residuum.
Offering a CGA is not without risk

Many philanthropic organizations have been willing to act like insurance companies by self-insuring their CGA programs. However, a CGA program does not come without risks — significant risks that can unfavorably impact the value of the gifts and the viability of the program. An April 2015 ACGA whitepaper noted that a disadvantage of self-insuring gift annuities is that it puts the charity at financial risk, which can include investment, longevity and concentration risks.³

It is important for a nonprofit organization to understand the impact of investment risk and the best procedures to minimize negative impacts to a portfolio. The 2008–2009 U.S. financial crisis caused several charities to go bankrupt and left them unable not only to repay their donors, but also to promote their missions. For CGAs, investment risk is best managed through diversified investment pools, asset allocation and asset-liability matching (ALM). But, as Brian K. Clontz and Donald F. Behan noted in a Journal of Gift Planning article, most CGA pools do not address ALM because charities “tend to invest every annuity in the same investment pool without regard to the expected timing of the liability.”⁴ Because charities do not use ALM, when the rate of return for a CGA pool is not high enough to meet the payments for the annuitants, a charity needs to make up the shortfall. This can have a negative and sometimes devastating effect on the financial viability of an organization. In contrast, Clontz and Behan note, “insurance company actuaries build pools asset/liability models to project future cash flow needs.” Reinsuring through an established insurance company gives a charity protection against lower returns and financial losses due to market volatility.

Longevity risk is the risk of an annuitant living longer than their expected actuarial mortality. In the event the annuitant outlives his or her life expectancy, a charity is obligated to continue making CGA payments since they have been guaranteed for as long as the annuitant lives. If someone dies earlier than expected, then in theory, the residuum can be released. But, if there is another donor still alive well past their expected mortality, the residuum from the person who died sooner might actually not be released, because the charity needs that to continue paying the person still living. Longevity risk can expose an organization to higher-than-expected payout rates and a need to supplement the payments with the charity’s revenues or general operating funds.

With concentration risk (i.e., when a CGA pool’s assets and liabilities are concentrated around a small number of annuitants), short periods of market underperformance and/or the impact of longevity risk may require additional contributions from the charity to shore up the outstanding obligations.
In addition, charities need to be aware of the regulations that govern CGAs, which differ by state. Most states require that a separate annuity reserve fund be created by the charity, but the specific requirements, including reserve and annual reporting requirements, vary. These administrative complexities can distract from a nonprofit’s mission.

**Minimizing risk and maximizing value through CGA reinsurance**

CGA reinsurance is actually a bit of a misnomer because the term “reinsurance” usually describes an arrangement where one insurance company cedes excess risk to another insurance company for a premium. In the context of CGAs, reinsurance is simply a financial management technique that helps to eliminate a charity’s exposure to various risks. It is not an all-or-nothing solution since organizations can choose which gifts, or portion of a gift, to reinsure.

Like the name implies, CGA reinsurance is insurance, not an investment. When an organization utilizes reinsurance, it is purchasing a guarantee from an insurance company to cover the organization’s annuity payment obligations.

There are a number of benefits to CGA reinsurance, including security and certainty; immediate access to donor funds; flexible administration; and, increased donor confidence.

**Security and certainty**

CGA reinsurance reduces uncertainty with the transfer of investment, longevity and concentration risks, eliminating the need to draw on other revenues or unrestricted dollars in order to meet donor obligations. A charity that reinsures its CGA program does not have to worry about the impact on its ability to cover obligations due to market volatility or donors living longer than expected. A charity can accept gifts of all sizes and not be concerned about how the exposure to large gift annuity amounts might impact the financial health of the organization.

**Immediate access to donor funds**

CGA reinsurance allows an organization to immediately use CGA donations, instead of waiting until a donor’s death. When a nonprofit organization reinsures a gift annuity, funds are released to the charity after the purchase of the reinsurance, with the charity immediately being able to use the difference between the remaining value of the gift and the cost of the annuity. What’s more, the transfer of risks undertaken by CGA reinsurance may free up capital and enable the organization to issue additional CGAs.
Flexible administration

Flexible administration options are provided in CGA reinsurance, with payments being made by the insurer either to the organization or directly to a donor or annuitant. According to the ACGA, gift annuity administration requires the “structure and resources to invest reserve funds, manage accounts, make annuitant payments and meet state and federal reporting requirements.” The transfer to an insurance company requires fewer of an organization’s resources to maintain the program, which allows an organization to focus more time on its primary mission.

Increased donor confidence

Importantly, CGA reinsurance gives donors confidence about the guarantee of lifetime payments. Employing an insurance company funding mechanism can make donors more comfortable with the amount of their donation — or may even increase the possibility of additional donations if potential donors know their CGAs will be backed by an insurance company.

When CGA reinsurance makes the most sense

The best candidates for CGA reinsurance are those charities that desire to use some money immediately, want the least amount of administration possible, and are risk-averse. Typically, these are organizations that have no excess reserves to tap into if a CGA exhausts. The size of an organization and its CGA program shouldn’t matter since charities of all sizes can all benefit from CGA reinsurance. However, according to MetLife’s proprietary research, larger charities are more likely than smaller charities to reinsure their CGAs. Similarly, the more gift annuity donations received, the more likely a charity is to purchase reinsurance. While an attractive alternative, CGA reinsurance is not necessarily a solution for every organization.

Here are two examples of organizations that have recently benefited from CGA reinsurance:

A New York-based religious organization with a longstanding CGA program —
This organization had a large block of CGAs (over 800 in total, including many relatively small gifts made long ago) and was concerned about the impact of the increasing lifespans of annuitants and stock market volatility on the organization’s financial health. The insurer reviewed the organization’s entire block of existing CGAs and determined reinsurance could immediately improve the program’s bottom line and reduce both its longevity and investment risk. The analysis identified nearly 150 CGAs in which the state-mandated reserves being held were actually higher than the cost to reinsure these gifts. A net gain
of over $70,000 was achieved for the organization through the purchase of CGA reinsurance. The client was also able to eliminate ongoing investment management fees and reduce their administration expenses for these CGAs, and especially liked that the insurance company guarantee would continue annuity payments as promised when these gifts were made.

**An Arizona-based nonprofit concerned about a few large gift annuities —**
This organization’s chief financial officer was concerned about the potential impact of a few large gift annuities on the finances of the overall organization, even though it had a relatively small CGA program. Additionally, the organization was interested in the ability to outsource the program’s administration (e.g., writing checks, providing tax reporting information, etc.). The organization purchased a CGA reinsurance contract, saying that it valued the insurance company’s expertise in fixed income investing and return guarantees that compare favorably with other investment alternatives. It also liked the ability to put a percentage of a CGA’s value to work immediately, while completely eliminating longevity and investment risk, and plans to reinsure future donor gifts.

**How does CGA reinsurance work?**

**Exhibit 1: Comparing the CGA vs. CGA reinsurance processes**

**Traditional CGA process**
Nonprofit organization retains all risks

- Donation made to nonprofit organization
- Annuity agreement created by nonprofit organization
  - Donor receives annuity payments and tax deductions
  - Delayed access to funds until donor’s death

**CGA reinsurance process**
Investment and longevity risk transferred to insurance company

- Donation made to nonprofit organization
- Annuity agreement reinsured by insurance company
  - Donor receives annuity payments and tax deductions
  - Immediate reserve release increasing organization’s cash flow
Exhibit 1 illustrates the traditional CGA process compared to the CGA reinsurance process. In the traditional CGA process, the donation is made to the nonprofit organization, and an annuity agreement is created to provide lifelong income payments to that donor. The nonprofit organization creates the necessary reserves and makes annuity payments to the donor. Access to funds generated by the gift is delayed until the donor’s death, and the organization realizes the residual gift at that time. The nonprofit organization retains all the risks and administrative functions. If assets underperform and/or the donor lives past estimated life expectancy, there can be a negative impact on the residual gift realized or, in some cases, a need to access general funds to meet payment obligations.

With CGA reinsurance, the same annuity agreement between a donor and an organization takes place. However, a secondary contract is created with an insurance company. In exchange for a portion of the initial gift, the annuity payments are made by the insurance company, ensuring that the organization keeps its promises to its constituencies and stakeholders. There is a release of reserves — the difference in the cost of reinsurance and the gift — that the organization can access immediately, thereby increasing the organization’s cash flow. As noted earlier in this article, the investment and longevity risks are transferred to the insurance company. The administrative functions are also transferred, eliminating investment management fees and requiring fewer of an organization’s resources to maintain the program. Payments can be made directly to the donor or to the organization.

With both processes, donors will still avail themselves all the tax advantages associated with making a donation to the organization. The initial contract remains unchanged with no impact to the donor.
Exhibit 2: Cost structure of CGA reinsurance

<table>
<thead>
<tr>
<th>Donation amount</th>
<th>CGA benefit</th>
<th>Insurer annuity cost</th>
<th>$ amount</th>
<th>% of original gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10,000</td>
<td>$510</td>
<td>$7,700</td>
<td>$2,300</td>
<td>23%</td>
</tr>
<tr>
<td>$25,000</td>
<td>$1,275</td>
<td>$18,400</td>
<td>$6,600</td>
<td>26%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$5,100</td>
<td>$72,200</td>
<td>$27,800</td>
<td>28%</td>
</tr>
<tr>
<td>$10,000</td>
<td>$510</td>
<td>$8,100</td>
<td>$1,900</td>
<td>19%</td>
</tr>
<tr>
<td>$25,000</td>
<td>$1,275</td>
<td>$19,600</td>
<td>$5,400</td>
<td>22%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$5,100</td>
<td>$76,700</td>
<td>$23,300</td>
<td>23%</td>
</tr>
</tbody>
</table>

Key assumptions:
1 Annual single life benefit amount based upon maximum CGA rate schedule effective November 7, 2016 (as approved by the American Council on Gift Annuities).
2 Illustrative cost based on MetLife purchase rates in effect on November 30, 2017.

Exhibit 2 illustrates reinsurance pricing for gift annuities as the size of the gift and CGA payment increase. Reinsurance prices for this exhibit were developed based off of each annuitant’s age and benefit amount with MetLife purchase rates in effect on November 30, 2017. The reinsurance prices are included in the column titled “Insurer annuity cost.” The gift amount less the insurer annuity cost is the $ amount of funds released by reinsurance. The % of original gift is the $ amount of funds released by reinsurance divided by the gift amount. In general, the % of original gift amount released by reinsurance increases as the size of the benefit amount increases. The driver behind this is that the fixed expenses associated with the contract become a smaller percentage of the total premium as the benefit amount increases. Looking at the $100K example for a male at age 70, the reinsurance the cost is $72K, thus releasing 28% of the initial gift or $27,800 immediately for use by the organization vs. waiting until the donor’s death.
Exhibit 3: Funds released by CGA self-insurance vs. CGA reinsurance

<table>
<thead>
<tr>
<th>Age at purchase</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>65</td>
<td>70</td>
</tr>
<tr>
<td>Life expectancy (under IAR 2012)</td>
<td>89</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td>65</td>
<td>70</td>
</tr>
<tr>
<td>Funds released at life expectancy</td>
<td>$46,000</td>
<td>$48,000</td>
</tr>
<tr>
<td></td>
<td>$41,000</td>
<td>$43,000</td>
</tr>
<tr>
<td>Value of funds today (self-insurance)</td>
<td>$21,000</td>
<td>$26,000</td>
</tr>
<tr>
<td></td>
<td>$18,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Value of funds today (reinsurance)</td>
<td>$23,000</td>
<td>$28,000</td>
</tr>
<tr>
<td></td>
<td>$20,000</td>
<td>$23,000</td>
</tr>
</tbody>
</table>

Reinsuring today allows you to immediately release the same amount of funds without the inherent risk exposure to your CGA program.

Key assumptions:
2. Annual Fund Return: 3.25%, net of expenses.
4. Value of Funds Today (self-insurance) based on Present Value (PV) of CGA donation discounted back from annuity contract maturity date to current date.

Looking at this another way, why would an organization want to pay 72% of the initial gift when we could potentially realize 50% of the gift at the time of the donor’s death? The key is the ACGA assumption of a 50% remainder to the charity is in the future at the time of the donor’s death. Exhibit 3 illustrates the present value of the funds comparing self-insurance vs. reinsurance. Reinsurance allows charities to immediately release approximately the same amount of funds without the inherent exposure to investment risks, longevity risk and fees for the duration they are managing the reserves and making the payments.

The Society of Actuaries’ 2012 Individual Annuity Reserving Table, the IAR 2012 Mortality Table, required by a number of states for determining the minimum reserves required for gift annuities issued on or after January 1, 2015, was used to determine the life expectancy for each age and gender. Using the CGA rates and a gift amount of $100,000, the annual benefits are $4,700 for a 65 year old, $5,100 for a 70 year old, and $5,800 for a 75 year old, regardless of gender. At each individual’s life expectancy, the residual amount of the gift amount is determined, starting with the initial gift amount ($100K), reducing that for the annual benefit, and
assuming a return of 3.25% for each year until the life expectancy age. This amount is called the “funds released at life expectancy” in Exhibit 4 above, and it assumes that each individual dies at their life expectancy. The value of funds today (self-insurance) is the residual amount discounted back to the age at purchase using the 3.25% rate-of-return assumption. The value of funds today (reinsurance) is the gift amount ($100K) less the cost of reinsurance for each individual determined as of November 30, 2017.

There is not a significant difference between ages and genders when the value of funds today is compared for self-insurance against reinsurance. It also shows that at the IAR 2012 life expectancy age, the present value of reinsurance is greater than that of self-insurance. However, this is only one assumption for when the annuitant may die. Exhibit 4 illustrates residual amounts at different ages for the participant circled in Exhibit 3.

**Exhibit 4: Longevity protection**

<table>
<thead>
<tr>
<th>Age at death</th>
<th>89</th>
<th>90</th>
<th>95</th>
<th>101</th>
</tr>
</thead>
<tbody>
<tr>
<td>Description of age</td>
<td>Reinsurance</td>
<td>Life expectancy of IAR 2012 Table</td>
<td>5 years past IAR life expectancy</td>
<td>11 years past IAR life expectancy</td>
</tr>
<tr>
<td>Funds released at age (self-insurance)</td>
<td>N/A</td>
<td>48,000</td>
<td>29,000</td>
<td>0</td>
</tr>
<tr>
<td>Value of funds today (self-insurance)</td>
<td>$28,000</td>
<td>$26,000</td>
<td>$13,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

Exhibit 4 illustrates how reinsurance can help provide longevity protection for nonprofit organizations. The exhibit shows the funds released at age (self-insurance) and the value of funds today (self-insurance) at different possible ages of death. IAR 2012 mortality was used to determine life expectancy. Using the CGA rates, and a gift amount of $100K the annual benefit is $5,100 for a 70 year old. At each possible “age at death,” the residual amount of the gift amount is determined by starting with the initial gift amount ($100K) reducing that for the annual benefit and adding in a fund return of 3.25% for each year until the “age at death.” This amount is called the “funds released at age” in the chart above. The value of funds today (self-insurance) is the residual amount discounted back to the age at purchase (70) using 3.25%. The green column shows the value of funds today (reinsurance) and is the gift amount ($100K) less the cost of reinsurance for the sample individual determined as of November 30, 2017.
Using the IAR 2012 Mortality Table, the probability of living longer than age 89 is 56%, age 90 is 52%, age 95 is 28% and age 101 is 7%. The exhibit shows that age 89 is the equivalent age for where the value of funds today with self-insurance is equal to the value of funds released from reinsurance. The residual value quickly diminishes vs. what they could have realized with reinsurance after age 89. For individuals that live to age 101 or longer, the charity may lose money (or break even) from the gift annuity.

**Determining if CGA reinsurance is a good fit**

There is not a one-size-fits-all solution for mitigating risks for a CGA program and, while an attractive alternative, CGA reinsurance is not necessarily a solution for every organization. Organizations should develop CGA risk management policies that address the following questions:

1. What is our risk tolerance threshold for the management of the CGA program?
2. Up to what level do we want to self-insure, and when should we consider reinsuring all or a part of the gift based on our risk-tolerance threshold?
3. Is there a minimum gift size that we do not want to administer?
4. What are the fees and administrative demands of the program; and what should we retain or outsource?
5. Could our organization benefit from increased up-front cash flow?

Ultimately, with CGA reinsurance through a well-established and experienced insurance company, charities can alleviate their exposure to a host of risks and make certain that their finances remain predictable, to ensure that their organizations keep their promises to donors. When selecting an insurer to reinsure CGAs, there are several criteria that a charity should consider. First, it is important for a charity to select an insurer with CGA reinsurance as a core competency to ensure that the charity is working with a provider who truly understands the need to balance the charity’s ability to promote its mission by freeing up its capital, while protecting the income stream that has been promised to valued donors in exchange for their generosity. It is also extremely important to select an insurance carrier with strong financial strength ratings to be certain the insurer is able to meet all of its payment obligations. Additional protections can be provided to the charity through state guarantee associations, up to certain limits, which vary by state. For more information on state statutory limits, please visit NOLGHA.com.
Conclusion

With 10,000 baby boomers retiring every day, there is an enormous opportunity for older Americans with philanthropic intent to secure lifetime income payments for themselves and their loved ones, while getting a tax deduction. As the number of CGAs grows, so will the number of organizations that may turn to CGA reinsurance. The ACGA's 2013 Gift Annuity Survey Report, the most recent survey for which data are available, showed a slight increase in the number of charities interested in CGA reinsurance. The 303 charities responding that reported issuing one or more gift annuities in 2013 were asked whether they purchased commercial annuities to “reinsure” the gift annuities they issue. Nine in ten charities (91%) reported they do not purchase commercial annuities at all, while 7% purchase some commercial annuities, and 2% reported that all gift annuities they issue involve the purchase of commercial annuities, a slight increase over the 6% and 1%, respectively, in the 2009 survey. This means that the percentage of charities reinsuring their annuities is up slightly since the wake of the 2008–2009 U.S. financial crisis.

The uptick in the percentage of charities reinsuring their CGAs indicates that awareness of the extensive benefits that CGA reinsurance can offer to charitable organizations is expanding. The percentage is likely to grow even further as more charitable organizations realize that working with an insurance company whose expertise lies in mortality and longevity risk management and asset-liability matching can mitigate the risks associated with managing CGAs, relieving some of the burdens that come with administering a CGA program and allowing the organization to focus on its core philanthropic purpose.

2 Not every state permits reinsurance. If reinsurance is permitted, the charity must investigate how reinsuring contracts impacts the charity’s state reserve requirements.