



National Conference on Philanthropic Planning

.....

October 14-17, 2009
National Harbor, Maryland

Conference Presentation Paper

©Partnership for Philanthropic Planning 2009. All rights reserved.

Charitable Gift Annuity Reinsurance: What It Is, What It Isn't, When It Works and When It Doesn't

In light of the economic environment, choose either the last 18 months or the last decade, charities are increasingly exploring reinsurance as a risk management strategy for gift annuities. While it is a relatively simple concept, charities and advisors have erroneous preconceived notions about the viability of reinsurance. This session will dispel some of the myths and clarify the actual costs and benefits of various reinsurance applications.

I. Risk Management 101

Risk is defined as actual outcomes being worse than expected. Simply, that something bad may happen. Once a risk is identified, the next step is to quantify the probability it could occur – how likely is it, and the severity of the negative event – how bad is it.

There are only four strategies to manage risk:

1. Risk Retention – Self-insuring the risk in total or to a certain threshold (e.g., a deductible). If a loss occurs, the risk is borne by the person or entity exposed.

For gift annuities, this simply means that the charity is self-insuring.

2. Risk Reduction – Reducing the risk by changing either the probability or severity of the loss (e.g. stop smoking, seat-belts, etc.).

For gift annuities, this may mean that the charity reduces the ACGA payout rate, has a minimum age above 65, has a maximum gift size and/or may have a less aggressive asset allocation.

3. Risk Transfer – Transferring risk by contract or other practical means to a third party. Generally, this connotes insurance but it also includes any other risk shifting via contract (e.g., real estate contract where seller is still liable for environmental issues, insurance contract making payments for any amount over the deductible, etc.).

For gift annuities, this usually means reinsurance but it can also include when other funds/charities remain obligated to pay for any future losses.

4. Risk Avoidance – Avoiding any of the activities that give rise to risk. So a person may just choose not to drive at all or sky-dive or take any medications.

For gift annuities, this may mean not offering a program or referring all prospects to a third party (e.g., a community foundation-type charity).

Three key tenants of risk management:

1. Don't risk a lot to make a little.
2. Don't risk more than you can afford to lose.
3. Know the probability/odds.

II. CGA Reinsurance Defined

Charitable gift annuity reinsurance is simply a financing technique whereby a charity chooses to purchase a commercial single premium immediate annuity (either an individual or group contract) as an asset to back its contractual life-income liability owed to the donor.

This contract typically precisely matches the terms of the charitable gift annuity (e.g., the same payout, timing, life-only payments, etc.). Further, the contract becomes an asset of the charity and the charity is also the payee unless it directs the life insurer to make payments to the annuitants.

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.

III. Reinsurance Prevalence

Reinsurance was infrequently used during the 1980s and 1990s with as little as three percent of charities purchasing reinsurance. Clearly, those time periods had very strong stock market returns which made reinsurance less attractive. According to the ACGA Surveys, by 2004, approximately eight percent of respondents used reinsurance at some level. Anecdotally, there is certainly some evidence to suggest that number will perhaps double given the 2008 market downturn and increased risk aversion.

III. Top Five Most Frequently Asked Questions

1. What happens if the insurance company goes bankrupt?

While the investment and longevity risk is shifted to the insurance company, the contractual liability to make the gift annuity payment remains with the charity. So if the insurance company completely defaults on its immediate annuity obligation, which has not yet occurred in our history (but certainly may in the future), then the charity is still responsible for making the payments.

More practically, however, another insurance company will buy the assets and corresponding liabilities, bankruptcy will force liquidation so that policy-owners receive some level of benefit, and state guaranty funds may then help supplement any remaining deficiencies.

The financial safety ratings are certainly a very important part of the process and generally, a minimum level would be an A.M. Best A+ rating and an 85+ Comdex Score.

2. How do we account for reinsurance for tax and state reserve purposes (donor and charity)?

The donor's tax situation – the income tax deduction and subsequent 1099Rs - should have no impact so long as reinsurance is not required by the charity (see [Rev. Rul. 62-137, 1962-2 C.B. 28](#)). In the rare situation that the donor or charity requires reinsurance, 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 the charity's perspective, every state allows a reserve reduction for the annuities that have been reinsured subject to certain state-specific requirements. Do note that CA, IL, WI and WA require a specifically designed reinsurance contract. It is important to design the product to meet the specific federal 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 1099Rs to the charity that will be completely wrong. *Do not send these 1099Rs to the donor under any circumstances.* Instead, generate the gift annuity specific 1099Rs and mail them to your donors.

3. Doesn't reinsurance cost too much?

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), but usually averages 60-65% of the original gift. 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 24 months younger than actual age,
2. a 5.25% gross or 4.25% 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 charities say, "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 past research, 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. So, the smaller, initial value after reinsurance caught and passed the traditional "self-insured" account between 2-5 years prior to life expectancy.

Also, charities will say, "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.

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 20-30% because of the longer projected 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. How is reinsurance disclosed to the donor?

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.

5. How does the life insurer manage the risks and how does the company and agent/broker make money?

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 portfolio at 6.25% - the internal rate of return might be 5.0-5.3% to Annuity 2000 life expectancy. *Important note: Gift annuitant life expectancies have be proven to be significantly longer than Annuity 2000 and therefore represent anti-selection to the insurance company and what can be a much higher internal rate of return (IRR) to the charity – see these specific calculations in Table 2 below.* 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.

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 (the standard industry-wide commission is 4%). There are generally no trailing fees, bonuses, benefits or any other hard or soft dollar payments made after the initial commission. There are also two or three highly-rated carriers offering non-commissioned products as well.

IV. Reinsurance Mathematics

Reinsurance is not always a quantitative decision. Other subjective reasons, in fact, are usually the primary drivers – e.g., risk aversion, desiring the money currently or a state reserve reduction solution. But the mathematical modeling can assist the decision making process nonetheless.

What follows are three kinds of calculations: 1. Projected Values After Reinsurance – Table 1, 2. Internal Rate of Return Impact by Anti-Selection – Table 2 and 3.

The first table shows the amount remaining after reinsurance at respective female ages (65 is 21.28% which means reinsurance required 78.72% of the gift) and how that amount would grow to ACGA-assumed life expectancy. So rather than a 50% future value residuum, if the 21.28% were invested at 6% net constant, there would be \$111,601 as a residuum, and so on.

TABLE 1 – Projected Future Values After Reinsurance

Female Age	ACGA Life Expectancy (LE)/Present Value After Reinsurance (PV)	Future Value at 6%	Future Value at 7%	Future Value at 8%
65	LE= 28.44 PV= 21.28%	\$111,601	\$145,762	\$189,907
70	LE= 23.53 PV= 27.75%	\$109,322	\$136,352	\$169,716
75	LE= 18.86 PV= 34.28%	\$102,874	\$122,805	\$146,356
80	LE= 14.60 PV= 38.92%	\$91,125	\$104,514	\$136,961
85	LE= 10.90 PV= 43.81%	\$82,681	\$91,591	\$101,365
90	LE= 7.88 PV= 51.21%	\$81,052	\$87,276	\$93,914

Assumes a \$100,000 CGA with the present value growing at a net constant rate of return to life expectancy. Note that the ACGA equity assumption is 9%. Reinsurance quotes accurate on 5/22/09.

The second table calculates the internal rate of return (net, constant) from the immediate annuity (the reinsurance) using the Annuity 2003 unisex life expectancy table and the gift annuity life expectancy table. This is an actual client case so some of the annuitants are female, some are male and some are joint. Also note that the gift annuitant life expectancy table is about 1-2 years *shorter* than the ACGA-assumed life expectancy. So using the ACGA assumptions would produce a higher internal rate of return (IRR). The key take-away is that the level of anti-selection against the insurance companies can be quantified, and is most prominent at older ages – those with the shortest life expectancies.

TABLE 2 – Internal Rate of Return Impact from Anti-Selection

Annuity 2003 Unisex Table	Internal Rates of Return for Annuity 2003	Gift Annuitant Life Expectancies	Projected Internal Rates Of Return (IRR) Based on Gift Annuitant Life Expectancy
Contract #1611 - 3.8 years	5.31% Net	5.18 years	15.89% Net
Contract #1511 - 5.9 years	5.82% Net	7.97 years	12.47% Net
Contract #1216 - 23.2 years	6.77% Net	29.03 years	7.65% Net
Contract #1402 - 7.6 years	6.11% Net	9.97 years	10.76% Net
Contract #1316 - 7.6 years	6.11% Net	10.69 years	11.66% Net
Contract #977 - 12.2 years	6.27% Net	16.31 years	9.06% Net
Contract #439 - 13.9 years	6.34% Net	18.90 years	8.79% Net
Contract #329 - 7.6 years	6.11% Net	10.69 years	11.65% Net
Contract #1485 - 14.1 years	6.43% Net	16.20 years	7.68% Net
Contract #1116 - 6.3 years	5.87% Net	8.97 years	12.89% Net
Contract #1275 - 4.9 years	5.52% Net	6.50 years	13.18% Net

Finally, the third table is also an actual client case where they had approximately 6,000 contracts. But reinsurance was only recommended for the 12 representing concentrated risk. Looking at the last annuity for example, roughly half was needed for the reinsurance premium with the remaining amount that could be invested all equity or at least very aggressively (Immediate Surplus After Reinsurance). The additional columns show what that amount would grow to under various return assumptions. The charity projected that their self-insured portion would grow at 5.5% net. So the final column added up the projected gain over self-insurance for each annuity if the amount remaining after reinsurance could grow at 7% net, constant. If so, the charity would have an additional \$4.5 million over a self-insured program for these 12 annuitants.

TABLE 3 – Large Healthy Pool with Risk Concentration (2/10th of 1% represent 15%+ of the assets)

Market Value	Payment	Mode	Life Exp.	FV @ 5.5% Under Self-Insurance	Reinsurance Premium	IRR to Life Exp.*	Immediate Surplus After Reinsurance	FV @ 5.5% Investing Surplus	FV @ 7% Investing Surplus	Expected Gain Over Self-Insurance @ 7%
\$1,316,504.58	\$26,471.25	4	11.89	\$759,840	\$818,818	7.73%	\$497,687	\$940,648.00	\$1,135,775	\$375,935
\$1,103,485.03	\$19,239.79	4	11.6	\$841,625	\$613,768	6.82%	\$489,717	\$911,325.00	\$1,096,083	\$254,458
\$1,030,475.07	\$18,245.33	4	15.3	\$644,278	\$710,894	6.33%	\$319,581	\$725,009.00	\$922,110	\$277,832
\$2,273,332.84	\$18,585.96	12	9.35	\$1,078,927	\$1,290,354	11.17%	\$982,979	\$1,621,641.00	\$1,887,835	\$808,908
\$935,088.90	\$20,000.00	4	11.2	\$495,747	\$504,898	11.31%	\$430,191	\$783,589.00	\$937,143	\$441,396
\$1,314,562.96	\$11,256.24	12	8.59	\$627,288	\$733,417	11.56%	\$581,146	\$920,498.00	\$1,058,442	\$431,154
\$753,034.52	\$6,634.78	12	8.52	\$339,180	\$458,433	9.81%	\$294,602	\$464,884.00	\$533,941	\$194,761
\$1,294,445.45	\$14,454.72	12	5.97	\$566,077	\$699,551	13.98%	\$594,894	\$818,948.00	\$902,410	\$336,333
\$729,275.67	\$18,416.00	4	10.6	\$252,517	\$509,027	8.57%	\$220,248	\$388,497.00	\$458,953	\$206,436
\$1,559,101.52	\$16,575.00	12	7.09	\$580,683	\$944,579	12.07%	\$614,523	\$898,250.00	\$1,007,979	\$427,296
\$1,037,905.89	\$8,720.16	12	8.52	\$522,539	\$612,633	9.37%	\$425,273	\$671,085.00	\$770,774	\$248,235
\$1,999,400.03	\$16,662.00	12	7.25	\$1,200,069	\$989,245	11.21%	\$1,010,155	\$1,503,721.00	\$1,675,529	\$475,460
									Total Projected Gain	\$4,478,204

Hopefully, these tables provide a starting point for the kinds of financial analysis and modeling that can be useful in the reinsurance decision-making process.

V. Ideal Insurance Carrier and Product Characteristics

The ideal life insurance carrier would have:

1. Excellent Safety Ratings – A+ or better A.M. Best and 85 or better Comdex Score
2. Low minimum and no maximum premiums
3. Contract that can be modified for state requirements
4. Low expenses/fees
5. Dedicated CGA product line (1099R options, staff service specialists, etc.)
6. Group and individual contract options
7. No minimum or maximum ages
8. Excellent initial and post installment service
9. Ability to issue contracts in all 50 states
10. Minimum 7-day premium lock

VI. Ten Specific Reinsurance Applications in Turbulent Times

1. Money Now! Total Reinsurance with Immediate Payout

This approach has two structures. First, the issuing charity reinsures most of the new gift annuities and then keeps the amount left over. This “surplus” can be used currently or can be invested to life expectancy or some other future time.

Second, the issuing charity – usually a community foundation, reinsures most of the new gift annuities and then immediately pays out the present value of the projected 50% future value residuum. All assumptions precisely follow the ACGA Rates Committee methodology. So rather than receiving an unknown amount at an unknown point in the future, the charity received a known amount exactly equivalent to the 50% residuum today. And then they have the flexibility to do what they wish.

2. “Under-Water” CGA Optimization: Solves for Longest Possible Payments

This approach tries to optimize for the longest payments possible. Past research indicates that only using the fixed income allocation for reinsurance and leaving the rest all equity projects the highest future values.

3. New York Reserve Requirement Mitigation: A Double-Kicker

Some charities are trying to reduce the potential “capital call” exposure – having to move money from endowment to meet the reserve requirements. This can be the case in many states but none more so than New York. In many cases, the cost to reinsure is lower than the base level New York reserve requirement, and there is no additional required surplus if the charity uses a qualifying reinsurance contract. So the charity can release both the excess up to the base level reserves plus the required surplus to use for other annuities without having to make any new additions.

4. Commercial Single Premium Immediate Annuity (SPIA): An Elegantly Simple Solution

Most charities are not registered in every state or don’t have a CGA program at all. So when a donor requests a gift annuity with a cash contribution, the prospective gift is usually declined. Instead, solve for the premium required for the donor to simply buy a commercial immediate annuity that exactly matches what the gift annuity payments would be. As an example, a donor may wish to receive a 7% CGA on a \$100,000 contribution. The donor would solve for premium required to pay \$7,000/year and find that the best quote is \$65,000. The donor could buy the annuity and then just donate the remaining \$35,000 to the charity. The charity has not issued a gift annuity – so no 1099Rs, contracts, registrations, accounting, etc. But it receives the gift as a result.

5. Large CGA Risk Mitigation: Collaring the Outliers

With large gift annuities, as they go, so goes the pool. In many cases, the largest outlier risks represent 1-3% of larger pools and are 20-100 times larger than the average annuity. So if that particular donor lives longer than expected, it is equivalent to 20-100 living longer than expected. The statistical measure is to look at gift annuities 2-3 standard deviations in the right tail of a normal distribution curve.

6. Required Reinsurance to Maximize Charitable Income Tax Deduction: AFR and Immediate Annuity Rate Arbitrage

In very rare circumstances, which primarily occurred in late 2008 and early 2009, the AFR rate is much lower than the internal rate of return provided by the immediate annuity. In these cases, it can be beneficial for the donor to require reinsurance because the premium would be lower than the present value of the life income. So it would create a larger deduction than a standard CGA.

7. Options for Unhealthy Gift Annuitants

Some immediate annuities provide for impaired risk underwriting. In essence, the more unhealthy the donor, the sooner the insurance company predicts he/she will die and therefore the higher the payments or the lower the premium. This usually does not benefit the charity enough to warrant this strategy, but if it is large concentrated risk or the donor wants to see the money used before death, then this is an option.

8. Isolating and Immunizing Longevity Risk: Chopping Off the Statistical Tail

In the past few years, immediate annuity products have been developed to only collar longevity risk. These products are similar to standard immediate annuities but they start at some fixed point in the future. If the

annuitant passes away before that time, then no benefit is usually paid in its purest form. This is almost exactly the mirror image of term life insurance. If the annuitant lives to the specified age then the annuity policy kicks in and makes the life-only payment.

9. Private Letter Rulings Clarify Reinsurance Rider Options and UBI Issues

In the last few years, two private letter rulings on reinsurance. The first, [Ltr. Rul. 200847014](#), confirmed the understood tax treatment of gift annuity reinsurance, but also clarified that a premium refund feature would not be prohibited under § 170(f)(10). Next, [Ltr. Rul. 200852037](#) made clear that reinsurance would not trigger any kind of unrelated business taxable income issues and that a premium refund feature would be acceptable. Some commentators have wondered why these letter rulings were necessary, but in particular with 170(f)(10) which requires the annuity to provide “substantially the same timing and amounts under reinsurance”, there was some ambiguity. The question was, “Could you do a 5 or 10-year period certain? Or would this violate the letter or spirit of substantially the same?”

10. The Stop-Loss Two-Step: Eating the Apple in Two Bites

Gift annuities can be reinsured immediately, or at some future time. Charities sometimes want to self-insure the gift unless the value drops to the point that it would take the entire current balance to reinsure. Effectively saying, “We want the upside potential, but we also never want to be under-water on a particular gift.” Also, charities with under-water annuities may reinsure just the fixed income portion and leave the rest all equity. At such time as the equity portion increased enough to reinsure the rest of the annuity, then they are assured of no additional losses.

This strategy is useful for very large CGAs but is clearly very difficult to monitor as all the variables are literally changing every day. But it does provide a quantitative trigger point on the up or down-side.

For case studies on these 10 applications, see Clontz, B. (2009), “Charitable Gift Annuity Reinsurance Part II: The Top 10 Unique Applications in a Turbulent Market.” Planned Giving Design Center. <http://www.pgdc.com/pgdc/charitable-gift-annuity-reinsurance-part-ii-the-top-10-creative-solutions-turbulent-times>

VII. Additional Readings on CGA Risk Management/Reinsurance

- Newton, M. and Clontz, B. (1998) “An Analysis of Commercial Insurance as an Alternative Gift Annuity Financing Option.” Journal of Gift Planning, National Committee on Planned Giving. <http://www.charitablesolutionsllc.com/files/GiftAnnuity1.pdf>
- Clontz, B. and Behan, D. (2004), "Optimizing Charitable Gift Annuity Risk Management: Collaring The Bear and The Grim Reaper." The Journal of Gift Planning. http://www.charitablesolutionsllc.com/files/journal_of_gift_plan.1st_quart.2004.pdf
- Clontz, B., (2004) "The Top Ten Charitable Gift Annuity Risks to Avoid: How Does Your Charity Stack Up?," Planned Giving Today, November. http://www.charitablesolutionsllc.com/files/top_10_cga_risks_to_avoid2.pdf
- Clontz, B. and Behan, D. (2005), "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." The Journal of Gift Planning, June 2005. http://www.charitablesolutionsllc.com/files/journal_of_gift_planning_2.pdf
- Behan, D. and Clontz, B. (2005), “Mortality of Beneficiaries of Charitable Gift Annuities.” Society of Actuaries <http://www.soa.org/research/life/research-mortality-beneficiaries.aspx>
- Clontz, B. and Atwood, G. (2006) – CGA Risk Management. Symposium speech at the ACGA conference.
- Clontz, B. (2007) , “Charitable Gift Annuity Reinsurance: The Top Ten Most Frequently Asked Questions.” Planned Giving Design Center. www.pgdc.com/usa/item/?itemID=342616

- Behan, D., Clontz, B. and Johnston, M. (2008), “Mortality of Charitable Remainder Trust Income Beneficiaries.” Sponsored by SunTrust Bank and Renaissance Trust.
- Clontz, B. (2009), “Charitable Gift Annuity Reinsurance Part II: The Top 10 Unique Applications in a Turbulent Market.” Planned Giving Design Center. <http://www.pgdc.com/pgdc/charitable-gift-annuity-reinsurance-part-ii-the-top-10-creative-solutions-turbulent-times>

VIII. Contact Information

Bryan Clontz, CFP®

President, Charitable Solutions, LLC

3713 Pine St.

Jacksonville, FL 32205

P: (404) 375-5496

F: (904) 339-9014

www.charitablesolutionsllc.com - a non-cash asset receipt/disposition, CRT/CGA investment management, insurance appraisal, charitable gift annuity risk management and reinsurance brokerage consulting firm

www.dechomai.org - a national donor advised fund dedicated to non-cash assets and charitable gift annuities

Charitable Gift Annuity Reinsurance:

What It Is, What It Isn't, When It Works and When It Doesn't

Bryan Clontz, CFP®

President, Charitable Solutions, LLC

www.charitableolutionsllc.com (404) 375-5496

Agenda

- **Risk Management 101**
- **CGA Reinsurance Defined**
- **What Risks are Transferred and What Risk Aren't?**
- **The Top Four Uses of Reinsurance**
- **What are the Tax, Accounting and State Regulation Implications?**
- **Does Reinsurance Cost Too Much?**
- **Future Value Projections**
- **How Does the Insurance Company and the Agent/Broker Make Money?**
- **Reinsurance vs. Fixed Income: An Alternative**
- **Case Study – Large Healthy Pool with Risk Concentration**
- **Ideal Carrier or Product Characteristics**
- **What Characteristics Make Reinsurance More Attractive or Less Attractive**
- **CGA Reinsurance: 10 Advanced Cases**
- **CGA Reinsurance Articles**

Risk Management 101

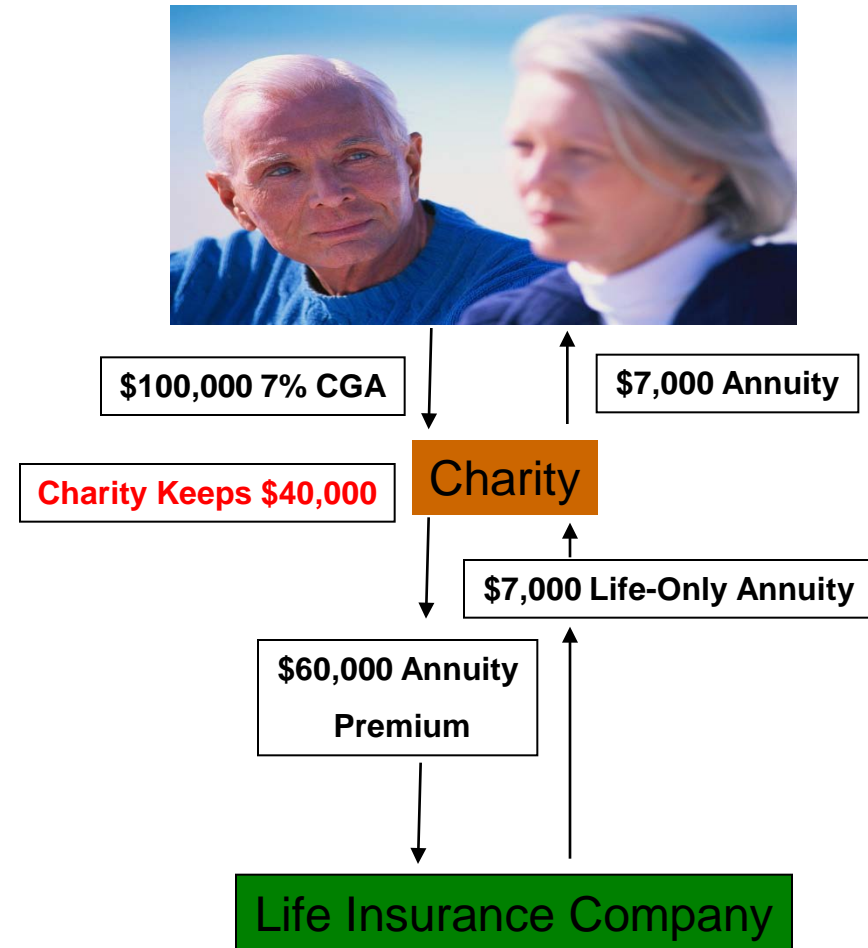
- **Actual Outcomes Worse Than Expected**
- **Event Frequency, Event Severity**
- **Risk Management Strategies**
 - Retain Risk (Total Assumption/Deductible or Self-Insurance)**
 - Reduce Risk (Stop Smoking or Reduce ACGA Rate)**
 - Transfer Risk (Insurance or Contract)**
 - Avoid Risk (Eliminate Activity)**

Three Rules to Remember:

Don't Risk a Lot to Gain a Little, Don't Risk More Than You Can Afford to Lose, Know the Odds

Reinsurance Defined

- 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 usually has no resemblance to true reinsurance — where one insurance company cedes excess risk to another insurance company for a premium.



What Risks are Transferred and What Risks Aren't?

- The longevity risk (the risk that donors will live past life expectancy) and the investment risk (the risk that average returns fail to meet assumptions or the timing of the returns generate early current losses) is transferred to the insurance company.
- If the life insurance company defaults, and another company does not take over its liabilities, and the state guaranty funds don't provide full coverage and the bankruptcy court and liquidation of assets does not make the liability whole, then the charity remains contractually liable to make the payments. This immediate annuity default scenario has never occurred in our history, but certainly could in the future.

The Top Four Uses of Reinsurance

- 1. Manage concentrated risks – reinsure the big ones.**
- 2. Investment alternative for fixed income – optimizing residuums.**
- 3. Mitigating reserve requirements – overall or for specific states.**
- 4. Money now – a goal for the donor or for the charity.**

What are the Tax, Accounting and State Regulation Implications of Reinsurance?

- **If the charity does not require the purchase of reinsurance, then all of the tax implications from a charitable income tax perspective and a 1099 perspective are identical to a non-reinsured gift annuity.**
- **All FASB calculations are the same as well. Charities first calculate the FASB liability and then, since the commercial annuity is owned by the charity, they book an asset with a value that exactly matches the calculated liability.**
- **Every state allows for a reserve reduction for reinsured gift annuities so long as the charity uses a qualified reinsurance contract. States requiring customized contracts are WA, IL, WI, CA and NY.**

Does Reinsurance Cost Too Much?

- **Compared to what?: The state reserve liability calculation, the FASB liability calculation, the charitable income tax deduction reflecting the life-income present value?**

Each of these calculations may use completely different assumptions for discount rates and life expectancies.

- **The benefit-cost analysis becomes – if we self-insure and model to life expectancy, what is the projected ending value vs. reinsurance?**

Future Value Projections

Female Age	ACGA Life Expectancy (LE)/Present Value After Reinsurance (PV)	Future Value at 6%	Future Value at 7%	Future Value at 8%
65	LE= 28.44 PV= 21.28%	\$111,601	\$145,762	\$189,907
70	LE= 23.53 PV= 27.75%	\$109,322	\$136,352	\$169,716
75	LE= 18.86 PV= 34.28%	\$102,874	\$122,805	\$146,356
80	LE= 14.60 PV= 38.92%	\$91,125	\$104,514	\$136,961
85	LE= 10.90 PV= 43.81%	\$82,681	\$91,591	\$101,365
90	LE= 7.88 PV= 51.21%	\$81,052	\$87,276	\$93,914

•Assumes a \$100,000 CGA with the present value growing at a net constant rate of return to life expectancy.

Note that the ACGA equity assumption is 9%. Reinsurance quotes accurate on 5/22/09.

How Does the Insurance Company and Agent/Broker Make Money?

- **The life company takes the premium and then buys institutional bonds to exactly match the future cash flows (asset-liability matching). It earns 7% on the bonds and then credits the annuity with 6% so they make the spread. They have no longevity risk (law of large numbers) and negative correlation with life insurance pools.**
- **The broker or agent usually earns a 3% commission, and the master broker/general agent usually earns 1% - so a total commission of 4%. Note that this would be the present value equivalent of a 36 bps (.36%) annual investment fee over 17 years.**

Reinsurance vs. Fixed Income: An Alternative

Annuity 2003 Unisex Table		CGA Gender-Specific Life Expectancies	
Contract #1611 - 3.8 years	5.31% Net	5.18	15.89% Net
Contract #1511 - 5.9 years	5.82% Net	7.97	12.47% Net
Contract #1216 - 23.2 years	6.77% Net	29.03	7.65% Net
Contract #1402 - 7.6 years	6.11% Net	9.97	10.76% Net
Contract #1316 - 7.6 years	6.11% Net	10.69	11.66% Net
Contract #977 - 12.2 years	6.27% Net	16.31	9.06% Net
Contract #439 - 13.9 years	6.34% Net	18.90	8.79% Net
Contract #329 - 7.6 years	6.11% Net	10.69	11.65% Net
Contract #1485 - 14.1 years	6.43% Net	16.20	7.68% Net
Contract #1116 - 6.3 years	5.87% Net	8.97	12.89% Net
Contract #1275 - 4.9 years	5.52% Net	6.50	13.18% Net¹

Large Healthy Pool with Risk Concentration

CGA Pool with 6,000+ contracts with 2/10ths of 1% representing 15% of Assets

Market Value	Payment	Mode	Life Exp.	FV @ 5.5% Under Self-Insurance	Reinsurance Premium	IRR to Life Exp.*	Immediate Surplus After Reinsurance	FV @ 5.5% Investing Surplus	FV @ 7% Investing Surplus	Expected Gain Over Self-Insurance @ 7%
\$ 1,316,504.58	\$ 26,471.25	4	11.89	\$759,840	\$818,818	7.73%	\$497,687	\$940,648.00	\$1,135,775	\$375,935
\$ 1,103,485.03	\$ 19,239.79	4	11.6	\$841,625	\$613,768	6.82%	\$489,717	\$911,325.00	\$1,096,083	\$254,458
\$ 1,030,475.07	\$ 18,245.33	4	15.3	\$644,278	\$710,894	6.33%	\$319,581	\$725,009.00	\$922,110	\$277,832
\$ 2,273,332.84	\$ 18,585.96	12	9.35	\$1,078,927	\$1,290,354	11.17%	\$982,979	\$1,621,641.00	\$1,887,835	\$808,908
\$ 935,088.90	\$ 20,000.00	4	11.2	\$495,747	\$504,898	11.31%	\$430,191	\$783,589.00	\$937,143	\$441,396
\$ 1,314,562.96	\$ 11,256.24	12	8.59	\$627,288	\$733,417	11.56%	\$581,146	\$920,498.00	\$1,058,442	\$431,154
\$ 753,034.52	\$ 6,634.78	12	8.52	\$339,180	\$458,433	9.81%	\$294,602	\$464,884.00	\$533,941	\$194,761
\$ 1,294,445.45	\$ 14,454.72	12	5.97	\$566,077	\$699,551	13.98%	\$594,894	\$818,948.00	\$902,410	\$336,333
\$ 729,275.67	\$ 18,416.00	4	10.6	\$252,517	\$509,027	8.57%	\$220,248	\$388,497.00	\$458,953	\$206,436
\$ 1,559,101.52	\$ 16,575.00	12	7.09	\$580,683	\$944,579	12.07%	\$614,523	\$898,250.00	\$1,007,979	\$427,296
\$ 1,037,905.89	\$ 8,720.16	12	8.52	\$522,539	\$612,633	9.37%	\$425,273	\$671,085.00	\$770,774	\$248,235
\$ 1,999,400.03	\$ 16,662.00	12	7.25	\$1,200,069	\$989,245	11.21%	\$1,010,155	\$1,503,721.00	\$1,675,529	\$475,460

Ideal Carrier and Product Characteristics

- **High Safety Ratings: A+ A.M. Best, 85+ Comdex Score**
- **Low minimum and no maximum premiums**
- **Contract that can be modified for state requirements**
- **Low expenses/fees**
- **Dedicated CGA product line (1099R options, staff service specialists, etc.)**
- **Group and individual contract options**
- **No minimum or maximum ages**
- **Excellent initial and post installment service**
- **Ability to issue contracts in all 50 states**
- **Minimum 7-day premium lock**

What Characteristics Make Reinsurance Attractive or Unattractive?

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

1. Older donors
2. Healthy donors
3. Immediate annuity payments
4. Female donors
5. Large gifts relative to the pool
6. Donor's who wish to see the money work immediately
7. Restricted gifts (such as those governed by fund agreement)

The converse of any these characteristics make reinsurance generally less attractive.

What Characteristics Make Reinsurance Attractive or Unattractive?

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

1. New or smaller pools
2. The charity's desire to use some money immediately
3. The charity desires the least amount of administration possible
4. The charity is organizationally risk averse
5. Financial modeling that projects higher ending balances under reinsurance vs. self-insurance
6. Charity wants to back out state reserve liabilities
7. There are no excess reserves or unrestricted money to draw upon if a CGA exhausts (*i.e.*, goes negative).

The converse of any these characteristics make reinsurance generally less attractive.

CGA Reinsurance: 10 Specialized Applications

- 1. Money Now! Total Reinsurance with Immediate Payout**
- 2. “Under-Water” CGA Optimization: Solves for Longest Possible Payments**
- 3. NY Reserve Requirement Mitigation: A Double-Kicker**
- 4. Commercial Single Premium Immediate Annuity (SPIA): An Elegantly Simple Solution**
- 5. Large CGA Risk Mitigation: Collaring the Outliers**
- 6. Required Reinsurance to Maximize Charitable Income Tax Deduction: AFR and Immediate Annuity Rate Arbitrage**
- 7. Options for Unhealthy Gift Annuitants**
- 8. Isolating and Immunizing Longevity Risk: Chopping Off the Statistical Tail**
- 9. Private Letter Rulings Clarify Reinsurance Rider Options and UBI Issues**
- 10. The Stop-Loss Two-Step: Eating the Apple in Two Bites**

CGA Reinsurance/Risk Management Articles

- **Newton, M. and Clontz, B. (1998) “An Analysis of Commercial Insurance as an Alternative Gift Annuity Financing Option.” Journal of Gift Planning, National Committee on Planned Giving.**
<http://www.charitablesolutionsllc.com/files/GiftAnnuity1.pdf>
- **Clontz, B. and Behan, D. (2004), "Optimizing Charitable Gift Annuity Risk Management: Collaring The Bear and The Grim Reaper." The Journal of Gift Planning.**
http://www.charitablesolutionsllc.com/files/journal_of_gift_plan.1st_quart.2004.pdf
- **Clontz, B., (2004) "The Top Ten Charitable Gift Annuity Risks to Avoid: How Does Your Charity Stack Up?," Planned Giving Today, November.**
http://www.charitablesolutionsllc.com/files/top_10_cga_risks_to_avoid2.pdf
- **Clontz, B. and Behan, D. (2005), "Optimizing Charitable Gift Annuity Risk Management Part II: Reinsurance Revisited." The Journal of Gift Planning, June 2005.**
http://www.charitablesolutionsllc.com/files/journal_of_gift_planning_2.pdf
- **Behan, D. and Clontz, B. (2005), “Mortality of Beneficiaries of Charitable Gift Annuities.” Society of Actuaries** <http://www.soa.org/research/life/research-mortality-beneficiaries.aspx>
- **Clontz, B. and Atwood, G. (2006) – CGA Risk Management. Symposium speech at the ACGA conference.**
- **Clontz, B. (2007) , “Charitable Gift Annuity Reinsurance: The Top Ten Most Frequently Asked Questions.” Planned Giving Design Center.** www.pgdc.com/usa/item/?itemID=342616
- **Behan, D., Clontz, B. and Johnston, M. (2008), “Mortality of Charitable Remainder Trust Income Beneficiaries.” Sponsored by SunTrust Bank and Renaissance Trust.**
- **Clontz, B. (2009), “Charitable Gift Annuity Reinsurance Part II: The Top 10 Unique Applications in a Turbulent Market.” Planned Giving Design Center.** <http://www.pgdc.com/pgdc/charitable-gift-annuity-reinsurance-part-ii-the-top-10-creative-solutions-turbulent-times>