# Protecting Your Gift Annuity Program From “Underwater” Gifts

May 23, 2019

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# Protecting Your Gift Annuity Program From “Underwater” Gifts

## Learning Objectives

1. What is an “underwater” gift annuity? How common are they?

2. What risks do “underwater” gifts pose to your program?

3. Why do  some gift annuities go “underwater”?

4. How do you identify at risk gifts?

5. What steps can be taken to reduce the impact on your program?

# What Is an "Underwater" Gift? How Common Are They?

"Normal" Gift Annuity — Gift assets cover all income beneficiary payments until death of final income beneficiary, 50% of original gift value remains for charitable beneficiary

"Underwater" Gift Annuity — Gift assets are exhausted before the death of the final income beneficiary, annuity runs out of money.

2017 Review of gift annuity programs administered by BNY Mellon showed:

- Nearly 50% of issuing organizations had at least one current underwater annuity
- Over 90% of issuing organizations had at least one projected underwater annuity

**It is almost certain that a charity issuing gift annuities will have an "underwater" gift!**

# What Risks Do “Underwater” Gifts Pose?

1. **Financial pressure on the annuity pool**
   – Distributions lead to declining assets, value of all gifts go down to cover losses

2. **Financial pressure on the charity**
   – Charity may need to use operating funds to cover annuity obligations

3. **Diversion of resources from mission-related activities**
   – Financial and human resources of the charity dedicated to a non-productive use

4. **Regulatory compliance risks**
   – Minimum reserve levels must be maintained in regulated states (NY, CA, FL, etc.)

5. **Damage to reputation**
   – Failure to fulfill charitable intent of donor, disappointment

6. **Lost opportunities**
   – Erosion of donor confidence, future gifts

# What Risks Do “Underwater” Gifts Pose?

High Effective Payout

Declining Assets

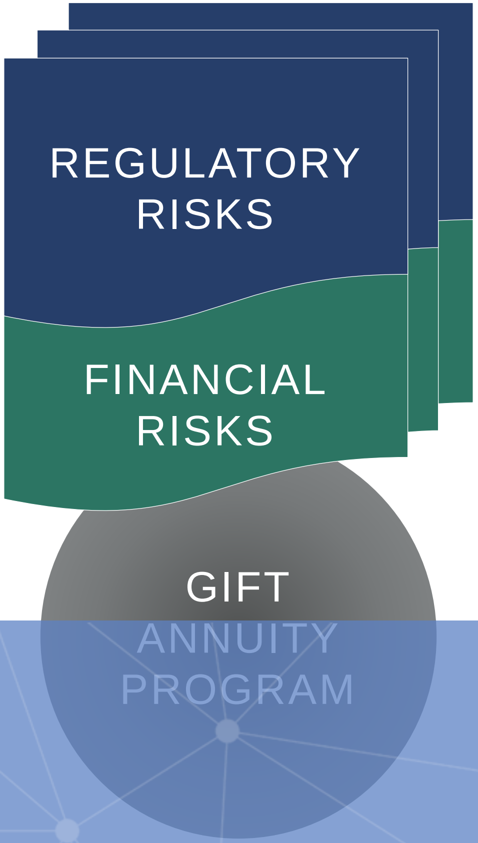

Need for Additional Funds

Diversion of Resources

# What Risks Do "Underwater" Gifts Pose?

Minimum Reserves

Scrutiny and Audits




Need for Additional Funds

Diversion of Resources

# What Risks Do “Underwater” Gifts Pose?

Disappointment

Erosion of Confidence


Negative Publicity

Loss of Future Gifts

# Why Do Some Gift Annuities Go "Underwater"?

1

## Inadequate gift structure and acceptance policies

- This is the most important factor in determining success or failure!
- Sound gift policies can prevent well-intentioned but risky decisions

2

## Donor Longevity

- Mortality tables and life expectancy estimates are far from precise
- Good chance that donors will outlive their life expectancy

3

## Lower Than Expected Investment Returns

- Market risk is inherent and unavoidable
- Disciplined and prudent management can reduce, but not eliminate, market risk

4

## Funding Asset Illiquidity and/or Insolvency

- Illiquid assets, hard to value assets
- Cash crunch or effective payout surprise

# Why Do Some Gift Annuities Go "Underwater"?

| | WITHIN CONTROL | OUTSIDE OF CONTROL |
|---|---|---|
| HIGH IMPACT | Gift Acceptance Policy<br>Gift Structure<br>Gift Asset | Investment Returns<br>Longevity<br>Timing of Gift<br>Solvency/Illiquidity |
| LOW IMPACT | Prudent Management<br>Diversification | |

# How Do You Identify At Risk Gift Annuities?

## Key Metrics for Monitoring Risks

**Average/Median Age**

– Helps to analyze age dispersion and potential pool longevity

**Effective Payout**

– How much of the gift's current market value is distributed as annuity payments

– Helps to identify the gift's ability to sustain annuity payments given the pool's rate of return

- Rule of Thumb: Pool ROR should be at least ½ of the pool's effective payout

**Annual Distributions by Annuitant**

– Percentage of an individual annuitant's payments of the pool's total payments

– Identifies the largest recipients of distributions

- Current Value? Projected Mortality?

**Projected Years to Exhaustion**

– Identifies gifts that have large discrepancy between expected mortality vs. expected years to exhaustion

# What Steps Can Be Taken?

## Reduce the Impact of “Underwater” Gifts on Your Program

1. Use Existing Annuity Pool Assets
2. Retain Unrestricted Terminations
3. Make Payments Out of Pocket
4. Infusion of Unrestricted Operating Funds
5. Relinquish Income Interest

# What Steps Can Be Taken?

## Don’t Panic!

– Underwater Gift Annuities Are Common and Not Necessarily a Disaster

## Assess the Scope of the Problem

– Number of gifts, amount of distributions, ultimate purpose of gifts

– What is the financial status of my annuity pool?

## Make a Plan

– How will distributions for underwater gifts be funded? For how long?

– Where will funding needs come from?

– Identify all stakeholders and communicate clearly to all

## Early Identification is Key

– Monitor the financial health of your program on a regular basis

– Review projected remainder and projected exhaustion of each annuity

– Seek help from experts

# Questions?

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# Disclosure Appendix

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