

California Improves Investment Opportunities for Charitable Gift Annuities SB 1088 and Its Implementation

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FLEXIBILITY AND RESPONSIBILITY

SB 1088, authored by Sen. Jack Scott (D, Pasadena) and sponsored by the Northern California Planned Giving Council (NCPGC), was signed into law by Governor Schwarzenegger on August 30. The bill, effective January 1, 2005, amends California Insurance Code Sec. 11521.2 to allow charities issuing charitable gift annuities in California to invest up to 50% of their gift annuity reserves in stocks traded on U.S. exchanges. This increase from the old limit of 10% provides more investment flexibility for gift annuity pools by permitting licensees to invest a greater portion of the pool's assets in equities.

For some institutions, this will mean that the asset allocation for their overall gift annuity pool will more closely resemble the portfolios for their other charitable assets, including charitable trusts and endowments. Carefully applied, the new law should, over the long term, result in significant additional funds available for charitable purposes.

This legislation, however, is not intended in any way to recommend an appropriate asset allocation. Any asset allocation changes should be carried out only after considerable study. Nor does the new law change any other aspect of gift annuity regulation in California designed to protect annuitants, including the licensing and filing requirements, and the requirement to maintain the reserve assets in a segregated trust account.

REGULATORY BACKGROUND

California requires that a portion of the required reserves (at least 90% under prior law, 50% under SB 1088) be maintained in specified governmental fixed income investments. The remaining portion (previously 10%, now 50%) can be invested in securities traded on the New York and American Stock Exchanges, regional exchanges, and NASDAQ.

The new law allows a charity with a typical mature gift annuity program portfolio asset mix of 45% stocks/55% bonds (including both reserves and surplus) to consider an investment shift to something closer to 70% stocks/30% fixed income. This latter asset allocation more closely approximates the permitted mix for charities in other states, including those that use a prudent investor standard for gift annuity investment. It also more closely approximates the mix California charities typically use, consistent with the California prudent investor standard, when investing their other charitable assets.

IMPLEMENTATION

Not Mandatory

Every organization should give very careful thought to any change in the investment allocation of its gift annuity pool. It is vital to remember that while increasing equity exposure up to the 50% reserve limit is permitted by SB 1088, it sets a ceiling, or potential maximum allocation; it should not be considered a target. A change is not required if it is not appropriate.

More equity allocation may be appropriate for some gift annuity programs, particularly more mature programs with larger annuity pools. Each organization should take into account the nature of its own gift annuity pool, including its size, number and age of annuitants, investment experience over time, and the amount being withdrawn from the pool for annuity payments. Any organization contemplating a change should first consult closely with its investment advisor and investment committee. It is important to remember that greater equity exposure also increases, incrementally, portfolio volatility (the variability of returns).

Client/Investment Managers Working Group

A number of the professional investment managers of gift annuity pools and some of their clients are now consulting with one another about how to implement this new law. Check with your investment manager to see if they have participated in these discussions. (If they would like, they may contact Paula Blacher, CFA, at Wells Fargo, blachepb@wellsfargo.com, to discuss these issues at greater length.) Two of the principal matters under discussion are:

- 1) Use of mutual funds. Consent from the Department of Insurance is needed prior to investing any of the required reserves in mutual funds or bank common trust funds (either equity or bond funds). These two vehicles provide the best way for most charities to comply with their fiduciary investment responsibilities,

unless the dollar amounts of the investments are quite large. Commingled vehicles such as mutual funds provide the best means for adequately diversifying portfolios and for gaining cost-effective access to professional money managers. However, the experience of a variety of money managers and attorneys advising charities is that Department of Insurance authorization to use mutual funds and common trust funds has become harder to obtain and that approvals have been inconsistent from organization to organization. There is also some debate as to whether or not licensees already granted authority to use an equity mutual fund up to 10% may increase the equity exposure up to 50% in the same fund without further approval.

2) Use of Exchange Traded Funds (ETFs). ETFs combine the advantages of stocks with those of index funds. Like stocks, they are publicly traded on the major stock exchanges, and like index funds, they provide diversification and have low expenses. A number of investment and legal professionals believe that existing law permits ETFs to be used for investment of California gift annuity reserves in the same way publicly traded stocks can be used, without Department of Insurance approval.¹ However, we are not aware of any California licensee that currently uses these instruments as part of its reserve portfolio.

LEGISLATIVE HISTORY

California charities owe much thanks to SB 1088's author and champion, Senator Jack Scott, and his Legislative Consultant Alison Merrilees. They thoroughly understood the complexities of charitable gift annuities and that passage of the bill would mean more money in the long run for California charities. They very effectively conveyed the message to their Senate and Assembly colleagues.

This issue had worked its way to the top of the NCPGC legislative agenda before the beginning of the legislative session in January 2004. Our initial effort was to prepare a financial analysis to confirm that these changes would have long-term benefit to charities without undue additional risk to annuitants. We accomplished that with a widely-distributed analysis that was never challenged as to its methodology and conclusions.

¹ For example, attorney David Wheeler Newman stated that "... [R]eserves may be invested in exchange-traded funds without the commissioner's consent, since ETFs fall within the statutory category of "securities listed and traded" on the NYSE, American Stock Exchange or NASDAQ. MS&K *Charitable Sector Letter, Vol. XII, No. 3, 2004*, "California Loosens Restrictions on Investment of Gift Annuity Reserves." Quoted with permission.

We were then fortunate to link up with Senator Scott. We were referred to him by the office of Senator Jackie Speier (D, San Francisco/San Mateo), Chair of the Senate Insurance Committee. Senator Scott and his staff had some familiarity with and interest in gift annuities resulting from Senate Insurance Committee hearings about commercial annuities held in the previous session. He was very open to working with us and authoring the bill.

Our initial approach was to apply the Prudent Investor Rule to gift annuity reserves. This is California's statutory standard for other investments. It was also the legislative approach to gift annuities taken in other states, including New York and New Jersey. However, early discussions with the Department of Insurance alerted us to their concern about the standard; they felt it was too subjective to be effectively regulated. We honored that concern and shifted to the 50% equity limitation that was finally enacted.

After further discussions with Department staff, they formally opposed the bill on the basis that the small 10% equity allocation was necessary to protect annuitants. Our policy arguments carried before both the Senate and Assembly Insurance Committees and the bill passed out of both houses, with only one opposing Assembly vote.

KUDOS

Finally, we thank the many organizations state-wide who supported the bill. Support from the Planned Giving Roundtables of Southern California, Orange County, the Inland Empire, and San Diego enabled the Northern California Planned Giving Council to speak on behalf of our professional colleagues statewide. Letters of support from dozens of prominent charities were crucial. We particularly caught the legislators' attention with the active involvement of the University of California, the California State University, and the Association of Independent California Colleges and Universities. California's non-profit community truly showed its tenacity and strength.

For further information, contact: legislative@ncpgcouncil.org.

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