

Article Title: ARCHIVE | Criteria | Insurance | Specialty: Separate Accounts Rating Criteria Data:

(EDITOR'S NOTE: —This article is no longer current. It has been superseded by "Evaluating Insurance Company Separate Accounts And Funding Agreement-Backed Notes," published April 21, 2004.)

The Evolving History of Separate Accounts The use of separate accounts by insurers has become a well-established practice. From their origin as vehicles for investment in variable annuity and variable life products, separate accounts have evolved into a means of providing a variety of product structures. A separate account is a segregated pool of assets held and owned by an insurance company but distinct from the insurer's general account. Initially, separate accounts developed as a way to provide contractholders with the investment results of a specific asset portfolio rather than the combined results of the insurance company's general account. In particular, the first separate accounts allowed a company to isolate the performance of a common stock portfolio for policyholders interested in making a larger investment in that asset class. Over time, investment options in separate accounts have expanded to include various asset classes. The accounts have become widely used by pension plan sponsors, individual pension plan participants, and individual buyers of variable annuities and life insurance who want to choose the investment strategy underlying the products they have purchased. Separate accounts can provide at least two distinct benefits compared with the general account: First, they make it possible to measure and, if desired, to credit the investment results of a specified asset pool. Second, by effectively segregating assets from the insurer's general account, separate accounts may provide enhanced credit protection for policyholders covered by that account. This second potential benefit will be examined more closely in this article. Use in the GIC Marketplace One area in which the use of separate accounts has evolved is the pension guaranteed investment contract (GIC) market. In the late-1980s, separate account GICs developed as a way to obtain the benefits of asset segregation. Credit concerns about insurance companies' general accounts also became a major impetus for separate account development after the highly publicized insurance company failures of the early 1990s. Whether a separate account actually does result in an improved credit situation for the GIC contractholder needs to be evaluated through legal and structural analysis, as discussed in more detail later. Separate account GICs are offered on a nonparticipating or a participating basis. Nonparticipating GICs are akin to traditional GICs offered through the general account and involve an insurance company guarantee of interest at a specified rate, repayment of principal at maturity, and benefit-responsive withdrawals at book value. The separate account in this scenario is a means of segregating the GIC liabilities and assets from the insurer's general account obligations. Participating GICs, although benefiting from the segregation of the separate account, also benefit (or suffer) from the investment results earned by assets in the account. The insurance company and the GIC purchaser together determine the asset classes to be included in the account and the level of guarantee to be provided by the insurer. The insurance company guarantee includes benefit-responsive withdrawals at book value and, in addition, may include a minimum guaranteed interest rate on the GIC (e.g., 0% or 3%) or a guarantee tied to the return of an index (e.g., the S&P 500). The ultimate rate earned by the participating GIC will be affected by the investment returns of the assets in the separate account. Legal Review--State Regulation Standard&Poor's has rated several transactions involving insurance company separate account obligations and has developed criteria for reviewing these transactions. The legal framework for Standard&Poor's evaluation of separate account obligations begins with the relevant state insurance laws. Variation in the legal and regulatory structures among different states increases the complexity of the review and, based on the level of comfort Standard&Poor's receives from the insurer's counsel, can lead to different conclusions in the rating process. State laws vary in the treatment of separate accounts, ranging from those that do not explicitly mention separate accounts to those that provide a general authority to establish separate accounts. In the best cases, the statutes provide very clear separate account definitions and discussions of how these accounts would be treated in the event of insolvency. A further consideration is how GICs specifically are viewed within the state regulatory scheme, particularly whether they are given policyholder status. Although insolvencies have occurred involving separate accounts, the circumstances under which a separate account might be consolidated with the insurer's general account remain substantially undefined. Furthermore, it is not clear in most states whether separate account performance guarantees from an insolvent insurer would rank as policyholder obligations. Additional uncertainty is created because, in some states, the status of

GICs as insurance policies has not been settled. In reviewing the counsel's analysis of state statutes and regulations, Standard&Poor's receives legal comfort regarding the language of the legislation and any correspondence with state regulators, and reviews legal opinions rendered by counsel as discussed below. Several states have passed separate account legislation that clearly addresses the "separateness" of these accounts, the availability of separate account assets to first satisfy separate account claims in full, and the treatment of separate account assets and liabilities in the event of insolvency. As an example, Missouri's statute clearly defines a separate account, authorizes establishment of separate accounts and their use with individual or group contracts, and provides that separate account income, gains, and losses shall be credited against that account without regard to other income, gains, or losses of the company. The statute goes on to state that the "portion of the assets of any such separate account equal to the...contract liabilities with respect to such account shall not be chargeable with liabilities arising out of any other business the company may conduct." Finally, Missouri's statute makes clear that any deficiency claim against the insurer's general account is a policyholder claim, entitled to priority over general creditor claims. There are several additional states that are considered to have strong separate account statutes. It should also be noted that in some states the contracts evidencing the obligations must contain statutorily mandated language to ensure separate account treatment. Standard&Poor's receives legal comfort that this language has been included in the contractual documents. Legal Review--Opinions Standard&Poor's considers the legal opinions rendered by counsel for the parties to the transaction being rated to be critical. The application of any statute, no matter how clearly worded, is subject to interpretation. Thus, the opinion of counsel in the state of the insurer's domicile is evaluated carefully. Specific questions that should be addressed include the following: Has the account been properly established under state law and the obligations duly authorized as separate account contracts by state regulators? Have any necessary regulatory approvals for the transaction been obtained? Do the contracts contain any statutorily mandated language necessary to secure separate account treatment? Is transferability of assets to or from the general account or other separate accounts permitted? If so, under what conditions? Could transfers into the separate account or payments of obligations by the separate account be voided or recaptured as a result of fraudulent transfer or preference laws? To what extent would the separate account assets be available to satisfy third-party claims, both prior to or after commencing any regulatory or court-ordered proceedings, specifically including those of the IRS, those arising under ERISA, or those of other creditors of the insurer? Would the separate account assets be deemed the property of the insurer's estate in case of liquidation or other regulatory or court-ordered proceedings? To the extent that they could be, the assets might be used for purposes other than meeting separate account liabilities. What would be the effect on the rated transaction or issue of a "freeze" on the insurer's assets in the event of insolvency? Because timeliness is a consideration in our ratings, Standard&Poor's must consider the possible impact of the regulator's actions. Who will assume supervision of the account during insolvency, liquidation, or rehabilitation proceedings? To what extent would the receiver or superintendent be able to exercise his or her equitable powers to prescribe a distribution of assets other than in accordance with the statute? Is the exercise of such powers likely? As with the issues surrounding the separate account status, Standard&Poor's also reviews legal opinions addressing the priority of payment of the rated obligations in the event of insolvency. Where the statutes of the state of domicile are not clear on this point, these opinions and any statements of the regulators play an important role in the rating process. Separate Account Obligations Rated Above the Company's CPA Rating In certain situations, it is possible for separate account obligations to be assigned a higher rating than the company's overall claims-paying-ability (CPA) rating. For this to occur, Standard&Poor's reviews whether the separate account will be maintained and treated separately from the insurance company's general account, including separate bookkeeping or other evidence of separateness. Standard&Poor's also reviews whether the separate account adheres to specified guidelines for investment policy and collateralization. In all cases in which the higher rating is sought, Standard&Poor's reviews opinions from legal counsel for parties to the transaction that the state law of the insurer's domicile allows for establishment of separate accounts and for the assets separately held to be used to first pay the separate account obligations in full before paying the general account or other claims. Standard&Poor's also receives written comfort that deficiency claims against

the separate account are payable by the general account. Furthermore, Standard&Poor;'s receives the insurer's certification that no liens or claims exist, either consensual or nonconsensual, on the separate account assets other than those of the separate account creditors. Standard&Poor;'s also considers whether the cash flow analysis of the account demonstrates that the assets will be sufficient to cover the insurance obligations as well as custodial and other fees if they will be paid prior to or on a parity with policyholder liabilities. Standard&Poor;'s also reviews legal opinions addressing the issues discussed earlier, namely that the separate account obligations will rank *pari passu* with insurance policy claims and that a state rehabilitator or other official would not be likely to change the terms of the obligation or exercise other equitable remedies that could affect payment in full to separate account policyholders. Beyond these general requirements, to rate an obligation two notches higher than the company's CPA rating, Standard&Poor;'s reviews whether the assets are effectively segregated from the general account, in the opinion of counsel to parties to the transaction, including whether they are separately held with and titled in the name of a third-party custodian for the benefit of the separate account claimants. In some states, it may be necessary for the insurance department to expressly agree to this custodial arrangement. To rate an obligation three notches above the CPA rating (the maximum allowed under Standard&Poor;'s criteria), in addition to having a separate custodian, Standard&Poor;'s reviews whether the insurer has granted to the separate account creditors a first perfected security interest in the separate account assets and all proceeds received under the relevant laws. The security interest should be granted, valid, and perfected upon closing of the transaction and not become effective merely on the occurrence of a trigger event. This first perfected security interest criteria assumes that relevant state law recognizes the priority of such a security interest and the ability to access the assets in a reasonably timely manner in the event of default or insolvency. Standard&Poor;'s requests the insurer's counsel to render an opinion regarding these issues. As with the custodial arrangement, it may also be necessary to obtain the state regulator's approval of the granting of the first priority security interest.

**Further Applications of Separate Account Analysis**

The separate account criteria described above have been applied in various rated transactions and are expected to be applied in future rating analyses. Rated transactions have involved GIC or similar obligations, such as funding agreements, issued by a separate account. Monoline-wrapped GICs provide an alternative entry to the GIC market for insurers who lack the high ratings needed to compete in this arena. Under this approach, a financial guaranty monoline insurer agrees to guarantee the life insurer's obligations under its GIC contracts, or performance of the separate account assets, using a surety bond or a GIC insurance policy. To provide a rating on the GIC obligations based on the financial guarantor's rating, Standard&Poor;'s reviews whether the assets supporting the GIC obligations are effectively segregated in a separate account that meets our criteria. The financial guarantor may ultimately have recourse to the separate account assets should its policy be drawn on to pay the GIC obligations. Additional underwriting and structural considerations are also reviewed. A structured GIC involves using a GIC product in various types of structured transactions. In these cases, the assets supporting the GIC are often segregated in a separate account to isolate the GIC obligation or its cash flows. In these transactions, the separate account obligation may not be directly rated, although it serves as the credit support (ultimately backed by assets in the separate account) for the rated obligations of a special-purpose entity. If payment of the rated securities is based on the separate account analysis, then the criteria discussed above should be satisfied. In addition, structured finance criteria apply as with any structured transaction.