

Bulletin 199

Claims paying ability and credit rating downgrade bail-out provisions in annuity contracts

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Recently, some insurers have been asked by pension plan sponsors, consultants, or brokers to include a specific contract provision in their guaranteed interest contract (GIC) and certain other deferred annuity forms. The provision would allow the contractholder to terminate the contract prior to maturity at book value in the event the insurer's claims paying ability or financial strength rating from a credit rating service firm was lowered after date of issue. The provision has become known as a "credit rating bail-out" provision and would trigger the right of the contractholder, or of all participants in participant directed plans, to withdraw their funds without imposition of market value adjustments or surrender charges in the event of a rating downgrade below some specified level.

Surrender charges and market value adjustment provisions are designed to protect against the risks associated with antiselection and disintermediation and to achieve equity between terminating and persisting policyholders. Waiver of these provisions upon trigger of a credit rating bail-out provision would be unfair, unjust and inequitable to persisting policyholders who would be required to subsidize the withdrawal activity of other policyholders. Additionally, such trigger could enhance the probability of a panic run of all policyholders following an initial surge of surrenders made pursuant to a credit rating bail-out privilege possibly leading to insolvency of the insurer.

Financial stress may occur in the event of a credit rating downgrade, but the existence of credit rating bail-out provisions can only increase financial problems and the likelihood of massive policyholder surrenders resulting in the need for regulatory intervention.

The Bureau will not approve any form containing a credit rating bail-out provision on the basis that such provision would be unfair, unjust and inequitable pursuant to 24-A M.R.S.A. Section 2413.

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