

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
San Francisco, California 94105

NOTICE OF PROPOSED ACTION AND
NOTICE OF PUBLIC HEARING

Date: August 6, 2010

Regulation File: REG-2008-00012

SUBJECT OF PROPOSED RULEMAKING

The Insurance Commissioner proposes to adopt the regulations described below after considering comments from the public. The Commissioner proposes to add to Title 10, Chapter 5, Subchapter 3 of the California Code of Regulations (“CCR”) the new Article 17.3: Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities, consisting of new Sections 2582, 2582.1, 2582.2, 2582.3, and 2582.4. (All references to the CCR in this Notice are references to sections in CCR Title 10.)

The regulations set forth updated minimum reserving requirements for life insurance. The regulations are for the most part the same as the National Association of Insurance Commissioners (“NAIC”) Model No. 815, titled “Model Regulation Permitting the Recognition of Preferred Mortality Tables for Use in Determining Minimum Reserve Liabilities,” the latest revisions to which were adopted by the Joint Executive Committee of the NAIC in September 2009.

The regulations differ from the NAIC Model in several respects, including the following: Changes were made to conform the Model to existing California minimum reserving requirements. The regulations have been clarified to expressly state that they apply not just to life insurance subject to California’s Standard Valuation Law but also to life insurance subject to the Fraternal Benefit Societies statutes which govern the minimum reserves for life insurance certificates issued by fraternal benefit societies. The regulations contain changes from the NAIC Model with regard to dates, punctuation, capitalization, references to authority, re-wording, and re-numbering. Some parts of the NAIC Model have not been included in the regulations because they either conflict with California requirements or because they are not necessary.

The regulations will replace Bulletin 2009-2, which was issued pursuant to California Insurance Code (hereafter “Insurance Code”) Section 10489.2. The Bulletin sets forth essentially the same requirements as the proposed regulations, but it does not apply to fraternal benefit societies. Bulletin 2009-2 expires on December 31, 2010.

PUBLIC HEARING

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to the proposed regulations, as follows:

Date and time: Tuesday, October 5, 2010 at 10:00 a.m.
Location: Department of Insurance
Administrative Hearing Bureau Hearing Room
45 Fremont Street, 22nd Floor
San Francisco CA 94105

The hearing will continue on the date noted above until all testimony has been submitted or until 5:00 p.m., whichever is earlier.

PRESENTATION OF WRITTEN COMMENTS; CONTACT PERSONS

All persons are invited to submit written comments on the proposed regulations during the public comment period. The public comment period will end at **5:00 p.m. on October 5, 2010**. Please direct all written comments to the following contact person:

Nancy Hom, Senior Staff Counsel
California Department of Insurance
45 Fremont Street, 24th Floor
San Francisco, CA 94105
Telephone: (415) 538-4144

Questions regarding procedure, comments, or the substance of the proposed action should be addressed to the above contact person. In the event the contact person is unavailable, inquiries regarding the proposed action may be directed to the following backup contact person:

Stesha Hodges, Staff Counsel
California Department of Insurance
45 Fremont Street, 24th Floor
San Francisco, CA 94105
Telephone: (415) 538-4428

DEADLINE FOR WRITTEN COMMENTS

All written materials must be received by the Insurance Commissioner, addressed to the contact person at her address listed above, **no later than 5:00 p.m. on October 5, 2010**. Any written materials received after that time may not be considered.

COMMENTS TRANSMITTED BY E-MAIL OR FACSIMILE

The Commissioner will accept written comments transmitted by e-mail provided they are sent to the following e-mail address: homn@insurance.ca.gov. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of Nancy Hom and sent to the following facsimile number: (415) 904-5729. **Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline set forth above for written comments.**

ACCESS TO HEARING ROOMS

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person(s) for the hearing in order to make special arrangements, if necessary.

AUTHORITY AND REFERENCE

The Insurance Commissioner proposes the adoption of Title 10, Chapter 5, Subchapter 3, Article 17.3, Sections 2582, 2582.1, 2582.2, 2582.3 and 2582.4 pursuant to the rulemaking authority vested in him by Insurance Code Section 10489.2 of the Standard Valuation Law and Insurance Code Section 11136 of the Fraternal Benefit Societies statutes, as well as the following decisions of the California Supreme Court: *CalFarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805 (1989), and *20th Century Ins. Co. v. Garamendi*, 8 Cal.4th 216 (1994). The Commissioner's decision on the proposed regulations will implement, interpret, and make specific the provisions of Insurance Code Sections 10489.2 and 11136.

INFORMATIVE DIGEST

SUMMARY OF EXISTING LAW AND POLICY STATEMENT OVERVIEW

California law requires that every insurer doing business in California and every fraternal benefit society transacting business in California file an annual statement with the Department of Insurance each year. Insurance Code Sections 900 and 11131. The annual statement must include certain financial information, including information on the sufficiency of the entity's reserves to cover future obligations such as claims. Insurance Code Sections 10489.15 and 11131.

In order to calculate life insurance reserves, an entity must have an actuarially based understanding of the expected mortality of its population of insureds. That data is set forth in mortality tables.

California statutes specify which mortality tables an entity may use in calculating its minimum reserve liabilities, i.e., in determining the minimum standard of valuation for the policies in question. Insurance Code Sections 10489.2 and 11136. Mortality tables are updated from time to time to reflect changes in the health and life expectancy of classes of insureds. Both Section 10489.2 and Section 11136 authorize the Commissioner to approve the use of updated mortality tables. Section 10489.2(a) states that for purposes of determining the minimum standard of

valuation for life insurance reserves governed by the section, a life insurer may use any ordinary mortality table adopted after 1980 by the NAIC that is approved by regulations promulgated by the Commissioner. Section 11136(b)(1) applies the same requirement to determining the minimum standard of valuation for life insurance certificates issued by fraternal benefit societies. The regulations proposed by the Commissioner approve the use of certain updated ordinary mortality tables adopted after 1980 by the NAIC, as authorized by Sections 10489.2 and 11136.

The policy underlying the proposed action is to allow actuaries to use the mortality tables that most closely match the emerging experience generated by an insurer's or a fraternal's insureds. This will help to make the actuaries' reserving calculations more accurate. There are obvious benefits in allowing the use of more recent mortality tables based on more current and more refined mortality information, as opposed to older mortality tables which may be less relevant to the health and life expectancy of current and future populations of insureds.

Use of the 2001 CSO Preferred Class Structure Mortality Table in place of the 2001 CSO Smoker or Nonsmoker Mortality Table in determining the minimum valuation standard for calculating reserves is expected to reduce the level of required minimum reserves for a particular product, and therefore is expected to result in reduced costs to life insurance companies and fraternal benefit societies choosing to use the newer tables. Consumers may also benefit to the extent these reductions reduce the cost of coverage.

Also, the purpose of the regulations is to prohibit insurers and fraternal benefit societies from reserving too little. The regulations allow these entities to use preferred mortality tables only if they refrain from using certain specified reserving methods in their statutory financial statements. This will prevent insurers and fraternal benefit societies from using preferred mortality tables in conjunction with these specified reserving methods in order to generate artificially low reserves. Without the restriction, insurers and fraternal benefit societies could be artificially understating reserves. This would be contrary to the Commissioner's application of California's reserving statutes (Insurance Code Sections 10489.2 and 11136), which require insurers and fraternal benefit societies to maintain certain minimum levels of reserves to ensure that they can meet their financial obligations to policyholders. In addition, this would be contrary to California's application of the Statement of Statutory Accounting Principles 61 and Appendix A-791 of the NAIC's *Accounting Practices and Procedures Manual* to insurers. Insurance Code Section 923 requires insurers to adhere to the NAIC's *Accounting Practices and Procedures Manual*.

The NAIC Model regulation also allows for the use of preferred mortality tables, and it imposes similar restrictions on use of the tables when certain other reserving methods are used. But it imposes the restrictions only on the valuation of policies issued prior to January 1, 2007. In contrast, California's restriction is not limited to policies issued during a particular time frame – it applies to all policies governed by the proposed regulation because there is no reason for California's regulations to treat the two groups of policies differently. Inadequate reserving practices should be prevented regardless of whether the policy affected is issued before or after January 1, 2007.

In addition to the above objectives, the purpose of the proposed regulations is to promote uniformity of standards among different states. At present, over 30 states have adopted some version of the NAIC Model. Both insurers and consumers can benefit if mortality table

standards become more uniform across various states. Insurers can do business more efficiently and their administrative costs are reduced, a cost reduction that can be passed on to consumers. The proposed regulations serve this purpose by ensuring that California's regulatory requirements are as consistent with those of other states as is possible under California law.

EFFECT OF PROPOSED ACTION

The effect of the proposed regulations is to allow an insurer or a fraternal benefit society to use the 2001 CSO Preferred Class Structure Mortality Table in place of the 2001 CSO Smoker or Nonsmoker Mortality Table as the minimum valuation standard for calculating reserves for policies issued on or after January 1, 2007, and, subject to the Commissioner's approval, for policies issued prior to January 1, 2007 which were valued using the 2001 CSO Mortality Table. Use of the Table is permitted for each calendar year of issue for any one or more specified plans of insurance, subject to satisfying the conditions stated in Article 17.3. Valuation actuaries will have the option of using the 2001 Preferred Class Structure Mortality Table if they decide it more closely matches the insurer's or fraternal's emerging experience with its population of insureds and the various classes of insureds within that population. For example, the 2001 CSO Preferred Class Structure Mortality Table may be a better match for business which, due to underwriting, is expected to have much better mortality experience than is assumed in the 2001 CSO Smoker or Nonsmoker Mortality Table.

The regulations place limits on when and how the 2001 Preferred Class Structure Mortality Table may be used. For example, the regulations provide that the 2001 Preferred Class Structure Mortality Table may not be used until the insurer or fraternal demonstrates that at least 20% of the business to be valued on the Table is in one or more of the preferred classes. A table from the 2001 CSO Preferred Class Structure Mortality Table used in place of a 2001 CSO Mortality Table, pursuant to the requirements of Article 17.3, will be treated as part of the 2001 CSO Mortality Table only for purposes of reserve valuation pursuant to the requirements of California Department of Insurance Bulletin No. 2003-5, "Recognition of the 2001 CSO Mortality Table for Use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits."

The regulations also prohibit insurers and fraternal benefit societies from reserving too little. The regulations allow these entities to use the preferred mortality tables only if they refrain from using certain specified reserving methods in their statutory financial statements. This will prevent insurers and fraternal from using preferred mortality tables in conjunction with these specified reserving methods in order to generate artificially low reserves. Without the restriction, insurers and fraternal could be artificially understating reserves. This would be contrary to the Commissioner's application of California's reserving statutes (Insurance Code Sections 10489.2 and 11136), which require insurers and fraternal to maintain certain minimum levels of reserves to ensure that they can meet their financial obligations to policyholders. In addition, this would be contrary to California's application of the Statement of Statutory Accounting Principles 61 and Appendix A-791 of the NAIC's *Accounting Practices and Procedures Manual* to insurers. Insurance Code Section 923 requires insurers to adhere to the NAIC's *Accounting Practices and Procedures Manual*.

The NAIC Model regulation also allows for the use of preferred mortality tables, and it imposes similar restrictions on use of the tables when certain other reserving methods are used. But it

imposes the restrictions only on the valuation of policies issued prior to January 1, 2007. In contrast, California's restriction is not limited to policies issued during a particular time frame -- it applies to all policies governed by the proposed regulation.

Additional conditions and limits on use of the 2001 CSO Preferred Class Structure Mortality Table are set forth in proposed Article 17.3.

The proposed regulations will promote uniformity of standards with those of other states by ensuring that California's regulatory requirements are as consistent with those of other states as is possible under California law.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents have been incorporated by reference into the proposed regulations:

1. The "2001 CSO Mortality Table," which consists of separate rates of mortality for male and female lives, developed by the American Academy of Actuaries CSO Task Force from the Valuation Basic Mortality Table developed by the Society of Actuaries Individual Life Insurance Valuation Mortality Task Force, and adopted by the NAIC in December 2002, published in the *Proceedings of the NAIC (2nd Quarter 2002)*, and supplemented by the 2001 CSO Preferred Class Structure Mortality Table. The 2001 CSO Mortality Table includes both the ultimate form of that table and the select and ultimate form of that table and includes both the smoker and nonsmoker mortality tables and the composite mortality tables. It also includes both the age-nearest-birthday and age-last-birthday bases of the mortality tables, the 2001 CSO Mortality Table (F) (meaning that mortality table consisting of the rates of mortality for female lives from the 2001 CSO Mortality Table), the 2001 CSO Mortality Table (M) (meaning that mortality table consisting of the rates of mortality for male lives from the 2001 CSO Mortality Table), the Composite Mortality Tables (meaning mortality tables with rates of mortality that do not distinguish between smokers and nonsmokers), and the Smoker and Nonsmoker Mortality Tables (meaning mortality tables with separate rates of mortality for smokers and nonsmokers).

2. The "2001 CSO Preferred Class Structure Mortality Table," which consists of mortality tables with separate rates of mortality for Super Preferred Nonsmokers, Preferred Nonsmokers, Residual Standard Nonsmokers, Preferred Smokers, and Residual Standard Smoker splits of the 2001 CSO Nonsmoker and Smoker tables, as adopted by the NAIC in September, 2006 and published in the *Proceedings of the NAIC (3rd Quarter 2006)*. The "2001 CSO Preferred Class Structure Mortality Table" includes both the ultimate form of that table and the select and ultimate form of that table. It includes both the smoker and nonsmoker mortality tables. It includes both the male and female mortality tables and the gender composite mortality tables. It also includes both the age-nearest birthday and age-last-birthday bases of the mortality table.

MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS

The proposed regulations do not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES OR SCHOOL DISTRICTS OR IN FEDERAL FUNDING

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

ECONOMIC IMPACT ON BUSINESS AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE

The Commissioner has made an initial determination that the adoption of the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurance companies and fraternal benefit societies. Although the Commissioner expects that the regulations will reduce costs overall because the regulations give entities the option of selecting mortality tables that enable them to lower their reserves, insurance companies and fraternal benefit societies may incur some administrative costs as a result of updating the way they calculate reserves.

The Commissioner has considered performance standards, but the Commissioner has identified no performance standards which would be as effective as the proposed regulations in permitting use of the 2001 Preferred Class Structure Mortality Table under Insurance Code Sections 10489.2 and 11136.

The Commissioner has not considered other proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses;
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses;
- (iii) The use of performance standards rather than prescriptive standards;
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

POTENTIAL COST IMPACT ON PRIVATE PERSONS OR BUSINESSES

The Commissioner has determined that for insurance companies and fraternal benefit societies subject to the proposed regulations there is likely to be some cost impact, although it will most likely be minimal. The cost impact would be the cost of changing some of the data which the insurer or fraternal uses in its reserve calculations, and the cost of calculating reserves in a more updated way than in the past. The cost impact of complying with the proposed regulations has already been mitigated by the fact that the Department of Insurance issued Bulletin 2009-2 on February 26, 2009. Bulletin 2009-2 allows insurance companies to use the 2001 CSO Preferred Class Structure Mortality Table in place of the 2001 CSO Smoker or Nonsmoker Mortality Table

under the same circumstances as the proposed regulations. Fraternal benefit societies were not included in the scope of the bulletin but are included in the scope of the proposed regulations, so the costs that they incur, if any, may be somewhat more than the costs incurred by insurers. The cost impact of the proposed regulations is further mitigated by the fact that the regulations allow insurers and fraternal benefit societies to use the 2001 CSO Preferred Class Structure Mortality Table in place of the 2001 CSO Smoker or Nonsmoker Mortality Table but they do not require that they do so. As noted above, the overall effect of the regulations is expected to be a reduction in insurers' and fraternal's costs.

The Commissioner is not aware of any cost impacts that a representative private person or business, other than the insurers and the fraternal benefit societies described above, would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON JOBS AND BUSINESSES IN CALIFORNIA

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of existing businesses, and the expansion of businesses currently operating in the state. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above, but he invites interested parties to comment on this issue.

FINDING OF NECESSITY

The Commissioner finds that it is necessary for the welfare of the people of the state that the regulations apply to businesses.

IMPACT ON HOUSING COSTS

The proposed regulations will have no significant effect on housing costs.

ALTERNATIVES

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purpose for which this action is proposed or would be as effective and less burdensome to affected private persons than the proposed action.

IMPACT ON SMALL BUSINESS

The Commissioner has made an initial determination that the adoption of the proposed regulations will not affect small businesses. Insurers are not small businesses under Government Code Section 11342.610(b)(2). Fraternal benefit societies are not small businesses because, under Insurance Code Section 10990, they are not for profit organizations. A nonprofit organization is not a small business under Government Code Section 11342.610(b)(6).

However, the Department invites public comments on the question of economic impact on small businesses.

COMPARABLE FEDERAL LAW

There are no existing federal regulations or statutes comparable to the proposed regulations.

TEXT OF REGULATIONS AND STATEMENTS OF REASONS

The Department has prepared an Initial Statement of Reasons that sets forth the reasons for the proposed action. Upon request, the Initial Statement of Reasons will be made available for inspection and copying. Requests for the Initial Statement of Reasons or questions regarding this proceeding should be directed to the contact person listed above. Upon request, the Final Statement of Reasons will be made available for inspection and copying once it has been prepared. Requests for the Final Statement of Reasons should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the express terms of the proposed regulations, the Initial Statement of Reasons, the information upon which the proposed action is based, and any supplemental information, including any reports, documentation and other materials related to the proposed action that is contained in the rulemaking file, is available by appointment for inspection and copying at 45 Fremont Street, 24th Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday.

AUTOMATIC MAILING

A copy of the proposed regulations and this Notice, including the Informative Digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Insurance Commissioner's mailing list.

WEBSITE POSTINGS

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Find at the righthand side of the page the heading 'QUICK LINKS.' The third item in this column under this heading is 'For Insurers'; on the drop-down menu for this item, select 'Legal Information.' When the 'INSURERS: LEGAL INFORMATION' screen appears, click the third item in the list of bulleted items near the top of the page: 'Proposed Regulations.' The 'INSURERS: PROPOSED REGULATIONS' screen will be displayed. Select the only available link: 'Search for Proposed Regulations.' Then, when the 'PROPOSED REGULATIONS' screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To browse, click on the 'Currently Proposed Regulations' link. A list of the names of regulations for which documents are posted will appear. Find in the list the "Recognition of Preferred Mortality Tables" link, and click it. Links to the documents associated with these regulations will then be displayed.

To search, enter “REG-2008-00012” (the Department's regulation file number for the regulations) in the search field. Alternatively, search by keyword ("preferred mortality tables" for example). Then, click on the 'Submit' button to display links to the rulemaking documents online.

MODIFIED LANGUAGE

If the regulations adopted by the Department differ from those which have originally been made available but are sufficiently related to the action proposed, they will be available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.