

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

INITIAL STATEMENT OF REASONS

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Regulation File: REG-2008-00012

INTRODUCTION

The Insurance 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 Initial Statement of Reasons are references to sections in CCR Title 10.) The Commissioner proposes to adopt the regulations pursuant to the authority vested in him by Sections 10489.2 and 11136 of the California Insurance Code (hereafter “Insurance Code”), 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.

The regulations are necessary in order to carry out the purpose of the statutes: to recognize and permit the use of mortality tables adopted by the National Association of Insurance Commissioners (“NAIC”) in determining minimum reserve liabilities for life insurance. The regulations are for the most part the same as the 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.

DESCRIPTION OF THE PUBLIC PROBLEM

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 Insurance Code Sections 10489.2 and 11136.

At present, there is a bulletin in effect that was issued pursuant to Insurance Code Section 10489.2, the same section that authorizes adoption of the proposed regulations as they apply to life insurers. Bulletin 2009-2 sets forth essentially the same requirements as the proposed regulations, but it does not apply to fraternal benefit societies. In addition, Bulletin 2009-2 expires on December 31, 2010. The regulations will replace Bulletin 2009-2.

The proposed regulations are necessary 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.

Another benefit may be reduced costs to insurers, fraternal benefit societies, and consumers. 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 may 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 regulations are necessary 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, the proposed regulations are intended 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. The proposed regulations are reasonably necessary to achieve this goal.

The overall purpose of the proposed regulations is to implement, interpret, and make specific the minimum reserving requirements of Insurance Code Sections 10489.2 and 11136 by specifying and clarifying which NAIC mortality tables insurers and fraternal benefit societies may use in determining the minimum standard of valuation for the policies in question. The overall objective is to facilitate, improve, and update California's the statutory minimum reserving requirements in a manner that, to the extent possible, is also consistent with the NAIC Model. The proposed regulations are reasonably necessary to accomplish these objectives.

SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR REGULATIONS:

The specific purpose of each regulation and the rationale for the Commissioner's determination that each regulation is reasonably necessary to carry out the purpose for which it is proposed is

set forth below. The sections of the proposed regulations are numbered differently from the corresponding NAIC Model sections so that the proposed regulations fit into the numerical sequence of the California Code of Regulations.

Section 2582 Authority

The purpose of Section 2582 is to set forth the authority for promulgating the proposed regulations. This section is reasonably necessary to identify and clarify the legal authority for the proposed regulations. Section 2582 re-phrases the NAIC Model section concerning authority to conform it to California law and to include fraternal benefit societies within the scope of the regulations. The section is otherwise the same as the Model. The changes are reasonably necessary in order to meet the requirements of California law and to include fraternal benefit societies within the scope of the regulations.

Section 2582.1 Purpose

Section 2582.1 provides that the purpose of Article 17.3, which contains the proposed regulations, is to recognize and permit the use of mortality tables that reflect differences in mortality between preferred and standard lives in determining minimum reserve liabilities in accordance with Insurance Code Sections 10489.2(a) and 11136(b)(1), and California Code of Regulations Section 2542.4 subsections (a) and (b). The purpose of Section 2582.1 is to identify and clarify the purpose of the regulations, the provisions of the Insurance Code being implemented, and the Code of Regulations section with which the proposed regulations are in accord. Section 2582.1 is reasonably necessary to clarify the purpose of Article 17.3.

Section 2582.1 differs slightly from the NAIC Model. Section 2582.1 refers to “Article” rather than “regulation” because “Article” is a more accurate reference. It states that the purpose of the Article is to “recognize and permit” the use of mortality tables, rather than “recognize, permit and prescribe” because the “recognize and permit” phrasing is a more accurate description of what the Article does. Also, the citations to authority in Section 2582.1 differ from the NAIC Model in that they have been tailored to California legal authority and they include fraternal benefit societies. These changes to the Model language are reasonably necessary in order to make the section more accurate, to conform it to California law, and to include fraternal benefit societies within the scope of the Article.

Section 2582.2 Definitions

The purpose of this section is to define “2001 CSO Mortality Table” and “2001 CSO Preferred Class Structure Mortality Table” as these terms are used in the proposed regulations. It is reasonably necessary to define “2001 CSO Mortality Table” and “2001 CSO Preferred Class Structure Mortality Table” to meet the clarity requirement of the Government Code and to eliminate any confusion about what is meant by these references.

Section 2582.2 is almost identical to its counterpart in the NAIC Model. Section 2582.2 differs

in that it contains the phrase “incorporated by reference herein” to comply with California Government Code requirements, a necessary change. Subsection letters that are upper case in the NAIC Model are lower case in Section 2582.2. The names of some tables have been capitalized so that they stand out, for greater clarity, whereas in the Model they are in lower case type. The reference to “NAIC Proceedings” in the NAIC Model has been corrected to “Proceedings of the NAIC” in Section 2582.2 subsection (b) for the sake of accuracy and clarity and also to be consistent with the reference to “Proceedings of the NAIC” in Section 2582.2 subsection (a). The regulation replaces the NAIC’s brackets around “3rd Quarter 2006” with parentheses to be consistent with the citation to the Proceedings of the NAIC in 2582.2(a), again, for clarity. Finally, subsection (c) of the NAIC Model which defines “statistical agent” is not included in Section 2582.2 because the proposed regulations do not contain this term, as explained later in this Notice, so the definition is unnecessary. If the definition were included it would create a lack of clarity.

Section 2582.3 2001 CSO Preferred Class Structure Table

The purpose of this section is to set forth the circumstances in which a company may elect to substitute the 2001 CSO Preferred Class Structure Mortality Table in place of the 2001 CSO Smoker or Nonsmoker Mortality Table as a minimum valuation standard. This section is reasonably necessary to eliminate confusion and to establish uniform rules governing when the Table may be used, and under what circumstances.

This section allows 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 minimum reserve liabilities 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 section provides 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.”

This section is the same as the NAIC Model, with a few differences. Section 2582.3 states that use of the table is subject to “satisfying the conditions stated in this Article” instead of the Model’s wording, “satisfying the conditions stated in this regulation,” because it would be inaccurate and confusing to refer to a singular “regulation” when what is meant is compliance with the entire article. The word “Article” was therefore substituted for “regulation” for accuracy and to meet the clarity standard of the Government Code. Similarly, the NAIC’s word “rule” is replaced with the word “Article” in the last sentence of Section 2582.3, for the same reasons. Section 2582.3 also replaces the NAIC’s reference to “NAIC Model Regulation” in the last sentence of the section with a reference to “California Department of Insurance Bulletin 2003-5,” which is the California-specific equivalent to the reference in the Model. This change was made to conform the reference to California law, for purposes of clarification.

Finally, Section 2582.3 allows 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 minimum reserve liabilities for policies issued prior to January 1, 2007 which were valued using the 2001 CSO Mortality Table, subject to the Commissioner’s approval. This wording differs somewhat from the NAIC Model, which provides that the 2001 CSO Preferred Class Structure Mortality Table may be used in place of the 2001 CSO Smoker or Nonsmoker Mortality Table as the minimum valuation standard for policies issued prior to January 1, 2007 and on or after the effective date of the adoption of NAIC Model Regulation 814, subject to the consent of the commissioner and the conditions of “Section 5” of the Model. In determining consent of the commissioner, the Model provides that the commissioner may rely on the consent of the commissioner of the company’s state of domicile.

Section 2582.3 differs from the NAIC Model in that the Model conditions use of the 2001 CSO Preferred Class Structure Mortality Table in part on the effective date of the adoption of NAIC Model Regulation 814. Model 814 is essentially the same as the 2001 CSO Mortality Table referenced in section 2582.3. Rather than refer to the Model and its adoption date, the Commissioner believes it is more direct, precise, and clear to simply condition use of the 2001 CSO Preferred Class Structure Mortality Table on the fact that a policy was valued using the 2001 CSO Mortality Table, for which the 2001 CSO Preferred Class Structure Mortality Table will be substituted. In addition, Section 2582.3 does not contain the NAIC’s phrase “subject to the conditions in Section 5” or an equivalent phrase because the entire Article 17.3 already applies to any policy valuation governed by Section 2582.3. Finally, the Commissioner has not deemed it necessary to incorporate the Model’s provision allowing him to rely on the consent of the commissioner of the company’s state of domicile in his decision-making process. The NAIC Model is a national model with provisions that are useful to states of varying sizes and review capabilities. The California Insurance Commissioner has adequate resources to make his own decisions as to approval, without relying on the commissioner of the company’s state of domicile to do so. Therefore it is unnecessary to include this provision of the NAIC Model.

The regulations, including the changes made to the NAIC Model, are reasonably necessary to

achieve the purposes stated above, for the reasons stated above.

Section 2582.4 Conditions

Except for the capitalization of a few letters, Section 2582.4 subsections (a) and (b) are the same as the corresponding provisions in Section 5 of the NAIC Model. Letters were capitalized for the purpose of fitting the text into the existing outline format and for the purpose of making the names of tables stand out more so they are clearer. These changes are reasonably necessary to achieve this purpose.

Section 2582.4(c) is the same as Section 5(c) of Bulletin 2009-2, which pre-dates Section 5 D of the NAIC Model. Although the language of Section 2582.4 differs from the language of Section 5 D of the NAIC Model, the substance of Section 2582.4 is essentially the same as the substance of Section 5 D of the NAIC Model. The Commissioner has determined that it is unnecessary and confusing to change the wording used in Bulletin 2009-2, and now in Section 2582.4, just to conform it to the wording of the NAIC Model, especially since the language has been in effect since issuance of Bulletin 2009-2 on February 26, 2009. Section 2582.4(c) differs from Section 5 D of the Model in that Section 2582.4(c) places limits on the use of the 2001 CSO Preferred Class Structure Mortality Table regardless of whether the policy in question was issued before or after January 1, 2007.

The purpose of Section 2582.4 is to prohibit insurers and fraternal benefit societies from reserving too little. Section 2582.4 allows 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 because there is no reason 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. The changes to the Model are reasonably necessary to achieve this goal.

The Commissioner has declined to adopt Section 5 C of the NAIC Model. Section 5 C contains reporting requirements for insurers that the Commissioner finds are unnecessary at this time. Existing California law is adequate to achieve the purpose of the reporting requirements.

Finally, the Commissioner has declined to adopt the final two sections of the NAIC Model concerning separability of regulation provisions and the effective date of the regulations. Both sections are unnecessary. Existing California law governs separability, and the effective date of the regulations will be stated in the final Form 400.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

IDENTIFICATION OF STUDIES

There are no technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the regulations. The Commissioner has relied upon the NAIC's Model Regulation (NAIC Model Regulation # 815) in proposing adoption of the regulations. A copy of NAIC Model Regulation #815 is included in the rulemaking file, along with copies of the two mortality tables incorporated by reference into the regulations: the 2001 CSO Mortality Table and the 2001 CSO Preferred Class Structure Mortality Table.

REASONABLE ALTERNATIVES TO THE REGULATIONS; IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department of Insurance, that would carry out the purpose for which the regulations are proposed or which would lessen any impact on small business. Indeed, the proposed regulations are not anticipated to affect small business. Neither insurance companies nor fraternal benefit societies are small businesses. Government Code Sections 11342.610(b)(2) and 11342.610(b)(6); Insurance Code Section 10990 (defining "fraternal benefit society" as a not for profit organization). Although performance standards were considered as an alternative, they were rejected as unreasonable and ineffective in addressing the problem of updating minimum reserve standards and promoting uniform regulation of reserve standards among various states and the NAIC.

ECONOMIC IMPACT ON BUSINESSES 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 would 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 that would be as effective as the proposed regulations in enforcing the statutes that form the basis for the proposed regulations.

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 or 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.

PRENOTICE DISCUSSIONS

The Commissioner has not conducted a prenotice public discussion of the proposed regulations pursuant to Government Code Section 11346.45 because he has concluded that the proposed regulations do not “involve complex proposals or a large number of proposals which cannot be easily reviewed during the comment period.” Government Code Section 11346.45(a).

The proposed regulations are for the most part the same as NAIC Model Regulation # 815. The NAIC Model Regulation is the product of NAIC-sponsored public committee meetings. Any interested party has had the opportunity to participate in the meetings and to comment on the changes to the NAIC Model Regulation at these meetings. The NAIC publicly finalized the revisions to the NAIC Model Regulation in 2009. The insurance industry generally follows NAIC activities, and interested parties are most likely already aware of the NAIC Model Regulation.

In addition, in February 2009 the Department of Insurance issued a bulletin (Bulletin 2009-2) which is almost exactly the same as the proposed regulations. Interested parties have had the opportunity to implement the terms of the bulletin since early 2009.