DEPARTMENT OF REGULATORY AGENCIES

Division of Insurance

3 CCR 702-3

NEW REGULATION 3-3-4

LIFE AND HEALTH REINSURANCE AGREEMENTS

Section 1 Authority

This regulation is promulgated under the authority of §§ 10-1-109(1), 10-3-118(6), 10-3-529(4), 10-3-1110, 10-6-129, 10-14-505 and 10-16-109, C.R.S.

Section 2 Scope and Purpose

A. The Colorado Division of Insurance recognizes that licensed insurers routinely enter into reinsurance agreements for many legitimate purposes. These purposes can include relief to the ceding insurer from strain to surplus.

B. However, it is improper for a licensed insurer, in the capacity of ceding insurer, to enter into reinsurance agreements for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business being reinsured. If, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged by the reinsurance transaction, notwithstanding certain risk elements in the reinsurance agreement, such as catastrophic mortality or extraordinary survival, the agreements violate:

1. Section 10-3-109, C.R.S. relating to financial statements that do not properly reflect the financial condition of the ceding insurer;

2. Section 10-3-118, C.R.S. relating to reinsurance credit for reinsurance, thus resulting in a ceding insurer improperly reducing liabilities or establishing assets for reinsurance ceded; and

3. Section 10-1-110(1)(i), C.R.S. and regulation 3-1-7 relating to creating a situation that may be hazardous to policyholders and the people of this State.

C. The purpose of this regulation is to establish requirements for acceptable reinsurance agreements to ensure that ceding insurers operate in a sound financial manner, correctly report their financial condition on required financial statements, and properly reduce liabilities or establish assets for reinsurance ceded. These requirements are necessary to protect the ceding insurers' policy and contract holders and the people of the State of Colorado.

Section 3 Applicability

This regulation shall apply to all domestic life, fraternal and health insurers and to all other licensed life, fraternal and health insurers that are not subject to a substantially similar regulation in their domiciliary state. This regulation shall also similarly apply to licensed property and casualty insurers with respect to their accident and health business. This regulation shall not apply to assumption reinsurance subject to Section 7 of Article 3 of Title 10, C.R.S.; yearly renewable term reinsurance; or certain nonproportional reinsurance such as stop loss or catastrophe reinsurance.

Section 4 Definitions

A. "Annual Statement" means the NAIC convention blank life, fraternal or health financial annual statement.

B. "Credit for Reinsurance" means any reduction of liability, establishment of asset or contra-liability, or any combination thereof.

C. "Credit Quality risk" means the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rates. It is commonly referred to as the "C1" risk.

D. "Division" means the Colorado Division of Insurance

E. "Disintermediation Risk" means the risk that interest rates rise and policy loans and surrenders increase, or that maturing contracts do not renew at anticipated rates of renewal. If asset durations are greater than the liability durations the mismatch will increase. Policyholders will move their funds into new products offering higher rates. The company may have to sell assets at a loss to provide for these withdrawals. It is commonly included in the "C3" risk.

F. "Financial Statement" means any monthly, quarterly or Annual Statement that is submitted to the Division.

G. "Lapse Risk" means the risk that the policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

H. "LTC" means Long-Term Care Insurance.

I. "LTD" means Long-Term Disability Insurance.

J. "Reinvestment Risk" means the risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase. It is commonly included in the "C3" risk.

Section 5 Accounting Requirements

All ceding insurers are responsible for establishing appropriate statutory gross reserves and reflecting appropriate credit for reinsurance, if any, for their reinsured business. A reinsurance agreement that does not comply with this regulation will be considered as a valid contract, unless terminated or voided by the parties to the agreement, where all terms and obligations are in effect, but no credit for reinsurance is permitted to be taken by the ceding insurer. The ceding insurer shall comply with the applicable provisions of law and this regulation before taking any credit for reinsurance in any financial statement for any reinsurance agreement.

A. No insurer subject to this regulation shall, for reinsurance ceded, reduce any liability or establish any asset in any financial statement filed with the Colorado Division of Insurance if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

1. Renewal expense allowances provided or to be provided to the ceding insurer by the reinsurer in any accounting period, are not sufficient to cover anticipated allocable renewal expenses of the ceding insurer on the portion of the business reinsured, unless a liability is established for the present value of the shortfall (using assumptions equal to the applicable statutory reserve basis on the business reinsured). Those expenses include commissions, premium taxes and direct expenses including, but not limited to, billing, valuation, claims and maintenance expected by the company at the time the business is reinsured;

2. The ceding insurer can be deprived of surplus or assets at the reinsurer's option or automatically upon the occurrence of some event, such as the insolvency of the ceding insurer, except that termination of the reinsurance agreement by the reinsurer for nonpayment of reinsurance premiums or other amounts due, such as modified coinsurance reserve adjustments, interest and adjustments on funds withheld, and tax reimbursements, shall not be considered to be such a deprivation of surplus or assets;

3. The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement, except that neither offsetting experience refunds against current and prior years' losses under the agreement nor payment by the ceding insurer of an amount equal to the current and prior years' losses under the agreement upon voluntary termination of in force reinsurance by the ceding insurer shall be considered such a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions that allow the reinsurer to reduce its risk under the agreement. An example of such a provision is the right of the reinsurer to increase reinsurance premiums or risk and expense charges to excessive levels forcing the ceding company to prematurely terminate the reinsurance treaty;

4. The ceding insurer must, at specific points in time scheduled in the agreement, terminate or automatically recapture all or part of the reinsurance ceded;

5. The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, it is improper for a ceding company to pay reinsurance premiums, or other fees or charges to a reinsurer that are greater than the direct premiums collected by the ceding company;

6. The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a representative sampling of products or type

of business, the risks which are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk categories:

a. Morbidity.

b. Mortality.

c. Lapse.

d. Credit Quality Risk.

e. Reinvestment Risk.

f. Disintermediation Risk.

\+ Significant
0 Insignificant

RISK CATEGORY	a	b	c	d	e	f
Health Insurance - other than LTC /LTD	+	0	+	0	0	0
Health Insurance – LTC/LTD	+	0	+	+	+	0
Immediate Annuities	0	+	0	+	+	0
Single Premium Deferred Annuities	0	0	+	+	+	+
Flexible Premium Deferred Annuities	0	0	+	+	+	+
Guaranteed Interest Contracts	0	0	0	+	+	+
Other Annuity Deposit Business	0	0	+	+	+	+
Single Premium Whole Life	0	+	+	+	+	+
Traditional Non-Par Permanent	0	+	+	+	+	+
Traditional Non-Par Term	0	+	+	0	0	0
Traditional Par Permanent	0	+	+	+	+	+
Traditional Par Term	0	+	+	0	0	0
Adjustable Premium Permanent	0	+	+	+	+	+
Indeterminate Premium Permanent	0	+	+	+	+	+
Universal Life Flexible Premium	0	+	+	+	+	+
Universal Life Fixed Premium	0	+	+	+	+	+
Universal Life Fixed Premium (dump-in premiums allowed)	0	+	+	+	+	+

7.

a. The credit quality, reinvestment, or disintermediation risk is significant for the business reinsured and the ceding company does not (other than for the classes of business excepted in Paragraph (7)(b)) either transfer the underlying assets to the reinsurer or legally segregate such assets in a trust or escrow account or otherwise establish a mechanism satisfactory to the commissioner which legally segregates, by contract or contract provision, the underlying assets.

b. Notwithstanding the requirements of Paragraph (7)(a), the assets supporting the reserves for the following classes of business and any classes of business that do not have a significant credit quality, reinvestment or disintermediation risk may be held by the ceding company without segregation of such assets:

(1) Health Insurance - LTC/LTD

(2) Traditional Non-Par Permanent

(3) Traditional Par Permanent

(4) Adjustable Premium Permanent

(5) Indeterminate Premium Permanent

(6) Universal Life Fixed Premium (no dump-in premiums allowed)

8. The formula for determining the reserve interest rate adjustment does not use a formula that reflects the ceding company's investment earnings and/or fails to incorporate all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

Rate = 2 * (I + CG) / (X + Y - I – CG)

Where: I is the net investment income as identified in the Annual Statement.

CG is capital gains less capital losses as identified in the Annual Statement.

X is the current year cash and invested assets plus investment income due and accrued less borrowed money, all as identified in the Annual Statement.

Y is the same as X but for the prior year.

9. Settlements are made less frequently than quarterly or payments due from the reinsurer are not made in cash within ninety (90) days of the settlement date.

10. The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured.

11. The ceding insurer is required to make representations or warranties about future performance of the business being reinsured.

12. The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer, typically on a temporary basis, while not transferring all of the significant risks inherent in the business reinsured and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

13. The reinsurance agreement contains provisions whereby the obligation of the assuming insurer to pay claims is conditioned upon some other event, such as the payment of reinsurance considerations. This does not preclude the reinsurer’s ability to terminate the agreement for breach or default of contract terms,

B. The following situations require the establishment of additional liabilities or limitations to credits taken by the ceding insurer.

1. Credit for reinsurance shall be allowed only to the degree of the risk transferred.

2. The ceding insurer shall not take any credit for reinsurance in excess of the gross reserve it has established for the portion of the business or risks being reinsured.

3. If commissions or other similar allowances received or credited to the ceding insurer are required to be repaid to the reinsurer, other than from emerging profits of the portion of the business reinsured, based on contract provisions or on future experience of the reinsured business, a liability shall be established or the credit for reinsurance reduced by the maximum amount of such future tentative repayment.

4. If the reinsurance agreement provides for financial guarantees by the ceding insurer to the reinsurer, a liability shall be established for the present value of such guarantee (using assumptions equal to the applicable statutory reserve basis on the business reinsured).

C. Notwithstanding Subsection (5) (A), an insurer subject to this regulation may, with the prior approval of the commissioner, take such credit for reinsurance or establish such asset as the commissioner may deem consistent with Section 10-3-118, C.R.S, regulation 3-3-3 or other actuarial interpretations or standards adopted by the Division.

D.

1. Agreements entered into after the effective date of this regulation which involve the reinsurance of business issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding company with the commissioner within thirty (30) days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement’s actuarial opinion with respect to valuation of reserves shall consider this regulation and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with this Division. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that such work conforms to this regulation.

2. Any increase in surplus net of federal income tax resulting from arrangements described in Subsection (5)(D)(1) shall be identified separately on the insurer's Annual Statement as a surplus item, and listed as an aggregate write-ins for gains and losses in surplus in the Capital and Surplus Account of the Annual Statement’s Balance Sheet. Further, the surplus increase shall be recognized as income and shall be reflected on a net of tax basis in the "Reinsurance ceded" line, on the Statement of Income page of the Annual Statement as earnings emerge from the business reinsured.

   For example, on the last day of calendar year N, company XYZ pays a $20 million initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a 34% tax rate, the net increase in surplus at inception is $13.2 million ($20 million - $6.8 million) that is reported on the "Aggregate write-ins for gains and losses in surplus" line in the Capital and Surplus account. $6.8 million (34% of $20 million) is reported as income on the "Commissions and expense allowances on reinsurance ceded" line of the Summary of Operations.

   At the end of year N+1 the business has earned $4 million. ABC has paid $.5 million in profit and risk charges in arrears for the year and has received a $1 million experience refund. Company ABC's annual statement would report $1.65 million (66% of ($4 million - $1 million - $.5 million) up to a maximum of $13.2 million) on the "Commissions and expense allowance on reinsurance ceded" line of the Summary of Operations, and -$1.65 million on the "Aggregate write-ins for gains and losses in surplus" line of the Capital and Surplus account. The experience refund would be reported separately as a miscellaneous income item in the Summary of Operations.

Section 6 Written Agreements

A. No reinsurance agreement or amendment to any agreement may be used to take any credit for reinsurance in any financial statement filed with the Division, unless the agreement, amendment or a binding letter of intent has been duly executed by both parties no later than the "as of date" of the financial statement.

B. In the case of a letter of intent, a reinsurance agreement or an amendment to a reinsurance agreement must be executed within a reasonable period of time, not exceeding ninety (90) days from the execution date of the letter of intent, in order for credit to be granted for the reinsurance ceded.

C. The reinsurance agreement shall contain provisions that provide that:

 1. The agreement shall constitute the entire agreement between the parties with respect to the business being reinsured thereunder and that there are no understandings between the parties other than as expressed in the agreement; and

 2. Any change or modification to the agreement shall be null and void unless made by amendment to the agreement and signed by both parties.

Section 7 Existing Agreements

Insurers subject to this regulation shall reduce to zero by December 31, 2007 any credit for reinsurance established with respect to reinsurance agreements entered into prior to the effective date of this regulation which, under the provisions of this regulation would not be entitled to recognition of the credit for reinsurance; provided, however, that the reinsurance agreements shall have been in compliance with laws or regulations in existence immediately preceding the effective date of this regulation.

Section 8 Filings

Per Section 10-3-118 (2), C.R.S., complete copies of all reinsurance contracts and agreements and other information desired shall be filed with the commissioner at the commissioner's request. Any information requested by the commissioner must be submitted no later than 20 days after receipt of the request. Insurers who fail to submit the requested information may be assessed a penalty up to $100 per day for each day after the date the information is due.

Section 9 Exceptions

A. A reinsurance agreement is not required to transfer all contract benefits contained in the underlying business reinsured. Transfer of less than all contract benefits is permitted if the reinsurance agreement is otherwise in compliance with this regulation and the benefits being reinsured: (i) are independent, distinct and severable from the contract benefits not transferred, and (ii) the reserves, and therefore the credit for reinsurance available to be taken by the ceding insurer, for the benefits transferred are independently calculated, distinct and severable from the reserves of the remaining contract benefits not transferred.

B. A ceding insurer, with the prior written approval of the commissioner, may have alternative terms or conditions in a reinsurance agreement, that are not otherwise in compliance with this regulation, if such alternatives are reasonably necessary for the protection of the public and the insured policyholders and substantially comply with the intent and provisions of this regulation.

Section 10 Severability

If any provision of this regulation or the application of it to any person or circumstance is for any reason held to be invalid, the remainder of this regulation shall not be affected

Section 11 Enforcement

Noncompliance with this regulation may result, after proper notice and hearing, in the imposition of any of the sanctions made available in the Colorado statutes pertaining to the business of insurance or other laws which include the imposition of fines, issuance of cease and desist orders, and/or suspensions or revocations of license. Among others, the penalties provided for in Section 10-3-1108, C.R.S. may be applied.

Section 12 Effective Date

This regulation is effective January 1, 2007.

Section 13 History

This regulation replaces, in part, Regulation 3-3-2.