STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 24th Floor
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INITIAL STATEMENT OF REASONS

Reinsurance Oversight

Date: May 1, 2017 **CDI Regulation File: REG-2016-00024**

INTRODUCTION

The California Department of Insurance (Department) proposes to adopt amendments to Title 10, California Code of Regulations (C.C.R.), Chapter 5, Subchapter 3, Article 3, sections 2303, 2303.1, 2303.2, 2303.4, 2303.5, 2303.8, 2303.9, 2303.11, 2303.12, 2303.13, 2303.14, 2303.15, 2303.17, 2303.19, 2303.21, 2303.22 and adopt sections 2303.23, 2303.24, 2303.25, 2303.26, 2303.27, and 2303.28, hereinafter referred to as "Reinsurance Oversight Regulations". (All references to the C.C.R. in this Initial Statement of Reasons are references to sections in C.C.R., Title 10.) The Department proposes to amend these sections and adopt new sections under the authority granted by California Insurance Code (Insurance Code) sections 720, 730, 736, 739.9, 922.8, 922.85, 923, 924, 1011.5, 1215.9, 1781.12, 10489.94 and 12921.

The Department proposes to amend sections 2303.1, 2303.4, 2303.5, 2303.8, 2303.9, 2303.11, 2303.12, 2303.13, and 2303.17 to update cross citations and typographical errors in these sections. Section 2303 will be amended to add reference to the proposed new sections in 2303.23 through 2303.28. Section 2303.2 will be amended to add definitions for sections 2303.23 through 2303.28. Section 2303.19 will be amended to make clear that the commissioner's discretion in section 2303.19 only applies to the original Reinsurance Oversight Regulations in sections 2303.1 through 2303.22. Section 2303.21 will be amended to update filing procedures.

In addition, the Department's proposed amendments to sections 2303.14 and 2303.15 remove references to a "volume insurer", a concept that is no longer applicable due to SB 1216, effective January 1, 2013, that amended Insurance Code section 922.6 and changed the commissioner's authority regarding credit for reinsurance accounting for foreign insurers. Changes from SB 1216 that related to credit for reinsurance accounting were undertaken by a non-substantive Section 100 filing made pursuant to section 100, Title 1, of the C.C.R. (OAL file: 2015-0212-01 N, approved in 2015) (hereinafter referred to as Section 100). However, sections 2303.14 and 2303.15 relate specifically to the commissioner's licensing authority in sections 700 and 717 of the Insurance Code, and thus could not be changed through a Section 100 filing. Other proposed amendments in sections 2303.15 and 2303.21 are a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and to update the regulations to reflect current department practice.

Section 2303.15(b) will also be amended to provide more accurate terminology for the commissioner's practice regarding the amount of business retained in a reinsurance contract with a non-affiliated company. As the regulation is currently written, a domestic insurer's reinsurance agreement with a non-affiliate will be found materially deficient unless 10% of direct written premium *per line of business* is retained. Pursuant to the commissioner's discretion in section 2303.19, it has been a practice to interpret *per line of business* to mean *per reinsurance agreement*, and require the 10% retention per reinsurance agreement. Section 2303.15(g) will be amended to allow for 100% cessions of direct written premium on prospective business from a California domestic to an affiliate or an intercompany pool without being conditioned on a 10% retrocession.

Sections 2303.22 relating to severability and 2303.23 regarding the effective date are proposed to be moved to sections 2303.29 and 2303.30, respectively, in order to include the new sections 2303.23 through 2303.28 into the regulatory scheme.

Finally, the Department is proposing to add sections 2303.23 through 2303.28 to clarify the provision of credit for reinsurance for term and universal life insurance reserve financing arrangements. The adoption of 2303.23 through 2303.28 are necessary to interpret, clarify, and make specific Insurance Code sections 922.4, 922.5 and 922.85, which establish when credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a deduction from liability on account of reinsurance ceded to specific reinsurers when specific forms of collateral have been posted in relation to term and universal life insurance reserve financing arrangements.

GENERAL DESCRIPTION OF THE PUBLIC PROBLEM

<u>Primer on Reinsurance, terms and concepts</u>

Reinsurance is an arrangement wherein the insurer, or cedent, transfers some or all of the risk that it has assumed under a policy or group of policies to a reinsurer. In this contractual relationship between the insurer and the reinsurer, the reinsurer agrees to indemnify the cedent for a portion of the premium as consideration for the risk assumed. As a contract of indemnity, the reinsurer's obligation is to reimburse the cedent for the agreed upon percentage of assumed risk, meaning the reinsurer does not owe the cedent anything unless and until the specific contractual requirements have been met. The reinsurer does not have any contractual liability to the policyholder as there is no privity of contract between the reinsurer and the insured, the obligations run solely between the insurer and the reinsurer, unless otherwise specified in the contract.

Every insurer doing business in a state must file financial statements reporting its condition and affairs as of the previous December 31. In California the requirement to make financial statement filings is in section 900 of the Insurance Code. The determination of the provision of credit on a cedent's financial statement for reinsurance is based on statutory accounting principles and regulatory requirements. These rules and laws determine when credit will be allowed to the cedent for reinsurance ceded as either an asset or a deduction from liability. In California, sections 922.1 *et seq.* provide when credit for reinsurance will be allowed to a domestic ceding insurer as an asset or a deduction from liability on account of reinsurance ceded when specific requirements are met.

Changes to Reinsurance Oversight Regulations Related to SB 1216 and Dodd-Frank

SB 1216 became effective January 1, 2013, and made many significant changes to the credit for reinsurance statutes found in sections 922.1 to 922.8 of the Insurance Code. Prior to SB 1216, section 922.6 of the Insurance Code gave the commissioner the authority to impose specific credit for reinsurance accounting requirements on foreign insurers. Foreign insurers are insurers that are domiciled in a state other than California. *See* Cal. Ins. Code § 27 (West 2017). Specifically, section 922.6(b) allowed the commissioner to disallow financial statement credit for cessions made to a foreign insurer on a finding that its condition or collateral would not satisfy the reinsurance accounting requirements applicable to California domiciled cedents. Thus, prior to SB 1216, section 922.6(b), in effect, provided a mechanism through which California was able to apply its own credit for reinsurance requirements on foreign insurers.

SB 1216 amended section 922.6 to prevent the commissioner from denying financial statement credit to a foreign ceding insurer to the extent that credit is recognized by the cedent's domestic state if that state is accredited by the National Association of Insurance Commissioners (NAIC) or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation. Meaning, the laws of the foreign insurer's domestic state will govern credit for reinsurance requirements for that insurer, and California no longer has the authority to impose reinsurance accounting requirements applicable to California domiciled cedents on foreign insurers.

The credit for reinsurance regulations in sections 2303 through 2303.25, except for 2303.14 and 2303.15, were updated in 2015 pursuant to a Section 100 filing. The Section 100 remedied inconsistencies in the regulation text that were superseded by changes to the Insurance Code as a result of SB 1216. For example, the Section 100 included references to "certified reinsurers" in the regulations, and it also removed references to the provision of credit for reinsurance for foreign or "volume insurers" throughout the regulations as they were no longer consistent with section 922.6 of the Insurance Code. Sections 2303.14 and 2303.15 relate specifically to the commissioner's licensing authority in Insurance Code sections 700 and 717, rather than his accounting credit authority in 922.6. Thus, sections 2303.14 and 2303.15 could not be changed with a Section 100 filing, and references to a "volume insurer" remain in sections 2303.14 and 2303.15. Amendment to sections 2303.14 and 2303.15 in this rulemaking will clean up these inconsistencies.

Additionally, proposed amendments in this rulemaking to sections 2303.14, 2303.15 and 2303.21 will memorialize Bulletin No. 2011-2, issued on April 11, 2011, to detail how the commissioner would exercise his regulatory discretion to comply with the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). In particular, Title V of Dodd-Frank, subtitled the Nonadmitted and

Reinsurance Reform Act, 15 U.S.C. §§ 8221-8223 (NRRA), provides that the laws of nondomestic states, except those with respect to taxes and assessments, are preempted to the extent they apply to reinsurance agreements. The commissioner's proposed amendments to sections 2303.14, 2303.15 and 2303.21 comply with Bulletin No. 2011-2 to achieve this end.

Term and Universal Life Insurance Reserve Financing

In 2013, the New York Department of Financial Services (NYDFS) published a whitepaper titled, Shining a Light on Shadow Insurance (whitepaper), that discussed financing mechanisms established by life insurers with captive insurance and/or offshore companies. The whitepaper described that in a typical transaction a life insurer would create a captive insurance subsidiary and enter into a reinsurance agreement wherein the life insurer cedes risks and reserves to the captive, the captive would collateralize the cession so the company could get statement credit, and then the non-economic reserves required to be held by the insurer for the now reinsured block of business would be diverted for other purposes. The non-economic reserves for certain term life insurance (known as "XXX reserves") or universal life insurance policies with secondary guarantees (known as "AXXX reserves") are a higher reserve requirement for universal life products that employ secondary guarantees. Companies have perceived the additional reserve requirements to be redundant reserve requirements, over and above what is required to be reserved for these products under reserving requirements for life products not involving secondary guarantees. Reinsurance agreements with affiliated captives allow life insurers to essentially "finance" these purported "reserve redundancies" by allowing insurers to use their non-economic reserves to finance an acquisition, increase executive compensation, pay shareholder dividends, or any other purpose an insurance company could conceive. In so doing, the non-economic reserves are not available to pay claims, thus defeating the very purpose of a reserve requirement.

Transfer of non-economic or redundant reserves to a captive raises concerns for two main reasons. First, instruments such as parental guarantees, letters of credit (LOC) and other LOC-like assets (e.g., credit-linked notes), rather than traditional admitted assets, are often used to back the non-economic reserves. Use of alternative instruments, like those described above, often means that the parent company is still responsible for paying claims when the captive's reserves are exhausted, and this presents a problem when the parent does not have adequate financial resources to do so if it has used its required non-economic reserves for another purpose. Second, reserve, collateral, and reporting requirements may be different for captives, which can create problems with the solvency of these captives and the transparency of these transactions. Often times these transactions were addressed by regulators on a case-by-case basis, meaning the applicable non-economic reserve calculations and asset quality standards for the collateral that secured the non-economic reserve differed from treaty to treaty and state to state.

After eleven months of investigation, the NYDFS whitepaper stated that New York based companies and their affiliates engaged in $48 billion of shadow insurance transactions, and in 80% of these transactions the companies failed to disclose the use of parental guarantees in their financial statements. NYDFS concluded that the weaker reserve buffers that resulted from these transactions not only put policyholders at risk that their claims may not be paid, but had the potential to put the stability of the broader financial market at risk.

The whitepaper was controversial, but it began a dialogue in the industry and at the NAIC about ways to make these transactions more transparent and sound without encouraging them to move offshore. The NAIC's first step was the creation of Actuarial Guideline XLVIII A*ctuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)* (AG 48), which was adopted by the NAIC in December 2014. AG 48 defines the rules for XXX and AXXX reserve financing transactions that are executed after January 1, 2015. AG 48 was the first step in the regulation of captive financing structures until revisions to the Credit for Reinsurance Model Law #785 (Model #785) and a new model regulation could be created. The NAIC also created a drafting group to write a model regulation, now known as the Term and Universal Life Insurance Reserve Financing Model Regulation #787 (Model #787), in October of 2014. Both AG 48 and Model #787 establish uniform minimum standards for securing the obligations under captive reinsurance treaties and reserve financing arrangements by providing an "actuarial method" to calculate the portion of the ceded reserves that must be collateralized by "primary security," and the types of assets that qualify as primary security.

In December of 2016, the NAIC adopted Model #787. The framework established in Model #787 is prospective. Model #787 does not change statutory reserve requirements for ceding insurers, rather it deals with the kinds of security, primary or other security, used to back the reserves in reserve financing transactions. Model #787 applies to reinsurance ceded to captive reinsurers, special purpose vehicles, or reinsurers that deviate from statutory accounting and/or risk based capital rules, and how credit for reinsurance can be obtained for ceded liabilities. Model #787 does not change a cedent's ability to obtain credit for reinsurance ceded to certified, licensed or accredited reinsurers, as defined in section 922.4 of the Insurance Code, that follow statutory accounting and RBC rules.

The NAIC intends for both the changes to Model #785 and the new Model #787 to become NAIC accreditation standards within the next few years. When an NAIC model becomes an accreditation standard, states must adopt the standard in a substantially similar manner in order to retain accreditation. The NAIC created the accreditation program as a way to promote effective financial solvency regulation of insurance companies by establishing baseline standards that state insurance departments must meet. A state obtains and maintains NAIC accreditation by demonstrating that it has met and continues to meet legal, financial and organizational standards determined by a committee of peer states. Currently, all 50 states, the District of Columbia and Puerto Rico are accredited. Accreditation standards evolve with industry practices. As new model laws and regulations are created or existing ones modified, the NAIC has established a process to allow for public comment and state voting to determine which models will become accreditation standards.

In sum, the proposed changes to the regulations are necessary to address various problems, including:

1) Address the problem of incorrect cross-citations and typographical errors throughout the regulations.

2) Address the problem of references to a volume insurer in the regulations, a concept that no longer exists in the regulations.

3) Address the problem of compliance with the NRRA in the regulations related to licensing, which is currently only found in Bulletin 2011-2.

4) Address the problem of confusing terminology in section 2303.15(b) and make clear the exercise of the commissioner's discretion in section 2303.15(g).

5) Address the potential problem of inconsistent application of section 2303.19 discretion regarding retention of business in a non-affiliated reinsurance agreement.

6) Address the problem of unclear filing procedures for certified reinsurer applications and the notice regarding reinsurance recoverables.

7) Address the problem of determining credit for reinsurance for term and universal life insurance reserve financing transactions with captive insurers, special purpose vehicles, and reinsurers that deviate from statutory accounting and/or risk based capital rules.

8) Adopt NAIC Model #787 for accreditation purposes.

The Department's proposed amendments to the regulations are described in more detail below.

SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR, PROBLEMS ADDRESSED BY, AND BENEFITS OF THE PROPOSED AMENDMENTS TO THE REGULATIONS (Government Code § 11346.2(b)(1))

The specific purpose of each amendment or addition, the problem the Department intends to address, and the rationale for the Department's determination is set forth for each affected section below.

Amend Section 2303.

The specific purpose of the proposed amendment is to make clear what sections embody California's reinsurance oversight regulations, and the types of transactions to which the sections apply.

The proposed amendment to change the reference to section 2303.25 to 2303.30 is reasonably necessary because with the commissioner's proposed addition of the new

Model #787 regulation language to the reinsurance oversight regulations will cause the regulations to go through section 2303.30 rather than 2303.25. Clear internal cross references makes understanding what provisions are encompassed in the oversight regulations easier.

The proposed amendment to remove the word "all" is intended to provide clarity regarding which insurers the regulations apply to. With changes proposed in other sections of the regulations, as a result of Dodd-Frank, some of the sections no longer apply to all insurers. For example, some of the requirements in the regulations relate only to California domestic insurers. Removing the word all from this general, overarching section, which introduces the regulations that follow, prevents confusion that the regulations are overreaching or the implication that the requirements that follow will impose restrictions on a broader group of insurers than they actually do.

The proposed amendment to include reference to the reserve financing arrangements pertaining to life insurance policies is reasonably necessary to explain that the reinsurance oversight regulations also apply to life insurance policies containing guaranteed nonlevel gross premiums, guaranteed nonlevel benefits and universal life insurance policies with secondary guarantees.

The proposed amendment to add authority citations is reasonably necessary to include the citations to the laws that provide the commissioner with the authority to adopt regulations that relate to the reserve financing transactions that sections 2303.23 through 2303.28 relate to. Providing correct authority citations is necessary to clarify what authority the commissioner is relying on to promulgate the regulations.

The proposed amendment to add reference citations is reasonably necessary to make clear what specific statutes the commissioner is implementing, interpreting, or making specific with these regulations. The additional citations relate specifically to the statutes regarding the reserve financing transactions that sections 2303.23 through 2303.28 relate to.

Amend Section 2303.1.

The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary because changing section 2303.25 to section 2303.22 reflects internal renumbering that will occur with the Department's proposed addition of Model #787 language into the reinsurance oversight regulations. The Department proposes to move and renumber section 2303.22, relating to severability, and section 2303.23, regarding the effective date of the regulations, to sections 2303.29 and 2303.30, respectively, in order to include the proposed new sections 2303.23 through 2303.28 into the regulatory scheme. By moving sections 2303.22 and 2303.23 to sections 2303.29 and 2303.30 unnecessary duplication of severability and date provisions in the scheme is avoided, and the new sections 2303.23 through 2303.28 are seamlessly incorporated into the regulatory scheme. Duplication of similar sections can be confusing, and makes the regulations cumbersome, thus the determination was to move and renumber sections 2303.22 and 2303.23, which resulted in the renumbering of other sections, such as section 2303.25. Correct internal cross references make the regulations clear and provide context.

<u>Amend Section 2303.2.</u>

The Department proposes to add nine definitions to the current definitions in the reinsurance oversight regulations. The specific purpose of the proposed amendments to this section is to add definitions that relate to the new Model #787 language. The addition of definitions is reasonably necessary to clarify specific terms that are used throughout sections 2303.23 through 2303.28 of the reinsurance oversight regulations. Defining these nine terms eliminates any confusion with interpreting, construing or applying their meaning in sections 2303.23 through 2303.28 of the regulations. The nine definitions have been incorporated into the existing regulatory scheme without any deviation in the language or substance from the definitions in Model #787. It is reasonably necessary to incorporate the definitions from Model #787 into the Reinsurance Oversight Regulations exactly as they appear in Model #787 because the definitions explain specific concepts in the Model. Not only would deviation from Model language create confusion, but because of the significance of definitions in a regulatory scheme it would likely result in the determination that sections 2303.23 through 2303.28 are not substantially similar to the Model and would not meet the accreditation standard.

The Department's proposal to incorporate these additional nine definitions will result in the renumbering of the definitions within this section of the regulations. The definitions in section 2303.2 are organized in alphabetical order, therefore to prevent confusion the Department proposes to incorporate the nine new definitions using the same alphabetical order.

<u>Subdivision (b)</u>

The addition of "Actuarial Method" to the definitions is necessary because the term "Actuarial Method" could mean many things, but as described in Model #787, and in the context of sections 2303.23 through 2303.28, this term is used to define a very specific actuarial methodology fully discussed in section 2303.26 of the regulations. In the context of sections 2303.23 through 2303.28, "Actuarial Method" means the method that is used to determine the required level of primary security for each reinsurance treaty subject to sections 2303.23 through 2303.28.

<u>Subdivision (d)</u>

The addition of the words "which have" change the words "that has" to correct the grammar in this subdivision.

<u>Subdivision (i)</u>

The addition of the term "Covered Policies" to the definitions is reasonably necessary because policies subject to regulation by sections 2303.23 through 2303.28 are specific types of policies. The policies subject to sections 2303.23 through 2303.28 or "Covered Policies," as described in Model #787, are non-grandfathered life insurance policies with guaranteed non-level gross premiums and/or guaranteed non-level benefits, except for flexible premium universal life insurance policies, and flexible premium universal life policies with provisions that result in the ability of the policyholder to keep the policy in force over a secondary guarantee period – also known as XXX and AXXX policies. By establishing a standard definition of what types of policies to which sections 2303.23 through 2303.28 relate eliminates confusion as to what policies are being regulated by these sections. Additionally, the term is used throughout sections 2303.23 through 2303.28, thus establishing a standard definition assists with the application of the regulations.

Subdivision (q)
The addition of the term "Grandfathered Policies" to the definitions is reasonably necessary to determine which Covered Policies are subject to the regulations based on the timeframe within which they were entered. The regulatory regime established in sections 2303.23 through 2303.28, and as described in Model #787, is prospective and does not apply to Covered Policies issued prior to January 1, 2015 and ceded as of December 31, 2014 as part of a reinsurance treaty that would not have met one of the exemptions described in section 2303.25. The addition of "Grandfathered Policies" to the definitions makes clear that policies within the established time period are exempt from this regulatory regime, which assists with the application of the regulations.

Subdivision (v)
The addition of the term "Non-Covered Policies" to the definitions is reasonably necessary to draw a distinction from Covered Policies. Covered Policies has a very specific meaning in the regulations, thus if a policy does not meet the definition of a Covered Policy it can fall into the classification of Non-Covered Policies. The term Non-Covered Policies is used in section 2303.26, which addresses the actuarial method. Section 2303.26, as detailed in Model #787, uses the term Non-Covered Policies to explain how credit for the ceded reserves will be determined if a reinsurance treaty cedes risks on both the specific types of policies known as Covered Policies and all other types of policies, or Non-Covered Policies. Credit for Non-Covered Policy reserves will be granted only to the extent that security is held by or on behalf of the cedent in accordance with sections 922.4 and 922.5 of the Insurance Code. Because the term Covered Policies establishes the type of policies subject to this regulation, defining the term Non-Covered Policies makes a clear distinction, in a succinct way, that the regulations only relate to those specific defined policies, thus eliminating confusion as to what policies are being regulated when applying the regulations.

Subdivision (w)
The addition of the term "Other Security" is reasonably necessary to draw a distinction from Primary Security. Primary Security has a very specific meaning in the regulations, thus if a form of security does not meet the definition of Primary Security it can fall into the classification of Other Security if it is a security that is found acceptable by the commissioner. Sections 2303.23 through 2303.28 of the regulations create a regulatory regime where funds consisting of Primary Security and Other Security are held by or on behalf of ceding insurers in the amounts required. While the term Other Security could mean many things, it must be described in this way because in the context of sections 2303.23 through 2303.28, the regulations establish that Other Security are funds that are held by or on behalf of the cedent under the reinsurance treaty in an amount at least equal to any portion of the statutory reserves that Primary Security is not held. By defining the

term Other Security a clear distinction is made that everything other than Primary Security is Other Security, when it is found to be acceptable by the commissioner, thus eliminating confusion when applying the regulations.

Subdivision (x)
The addition of the term "Primary Security" is reasonably necessary because the specific types of security that will be accepted as Primary Security is an essential subject to address the problem that Model #787 was created to remedy. The type of security that was acceptable to use to finance reserve transactions was often determined on a case-by-case basis and was addressed differently in different states. The definition of what constitutes acceptable security for purposes of these transactions, or Primary Security, establishes a uniform, consistent standard for what are acceptable forms of security, and makes implementation of the regulatory framework clear for insurers and regulators. The proposed definition of Primary Security, as described in Model #787, clearly establishes that certain types of security will be considered Primary Security, such as cash meeting the requirements of Insurance Code section 922.5; securities listed by the Securities Valuation Office that meet the requirements of Insurance Code section 922.5, with specific exclusions; and for security held in connection with funds-withheld and modified coinsurance reinsurance treaties commercial loans in good standing and of a specific quality, policy loans, and derivatives obtained in the normal course and used to hedge liabilities pertaining to actual risks in the ceded policies. By defining Primary Security in a specific way, there is no confusion regarding the type of assets that are acceptable. Additionally, when regulators in other jurisdictions review the financing transaction they will know what the Primary Security consists of in those transactions.

Subdivision (cc)
The addition of the term "Required Level of Primary Security" is reasonably necessary because in order to address the harm Model #787 was created to ameliorate, it is necessary to determine the specific amount of Primary Security necessary to be held by or on behalf of the cedent. Just as it was necessary to determine the type of security acceptable for Covered Policies, it is important to determine that the appropriate amount of that security is also being held. Required Level of Primary Security is used throughout sections 2303.23 through 2303.28, and it has a very specific meaning. As defined in Model #787, and in the proposed definition, the term Required Level of Primary Security is the dollar amount needed for each reinsurance treaty subject to sections 2303.23 through 2303.28 when the Actuarial Method has been applied to the risks ceded under Covered Policies. Thus, the Actuarial Method, as described in section 2303.26 is used to determine the Required Level of Primary Security. Establishing a uniform, consistent standard for what is the Required Level of Primary Security makes implementation of the regulatory framework clear for insurers and regulators.

Subdivision (ee)
The addition of the term "Valuation Manual" is reasonably necessary to make clear what valuation manual is referenced. The definition references section 10489.96(b)(1) of the Insurance Code, which is important because this language establishes the operative date of the valuation manual, so it is clear which valuation manual applies to the financial statement date when credit for reinsurance is being claimed. It also directs the reader to

the correct statutory reference. The definition in the proposed regulations is as it is defined in Model #787, which is important because if Model #787 becomes an accreditation standard it will be essential for California to use the same Valuation Manual as described in Model #787. Additionally, by creating a definition that clearly describes which Valuation Manual is used there will be more consistency in application as other states adopt Model #787.

Subdivision (ff)
The addition of the term "VM-20" is reasonably necessary because it is used throughout sections 2303.23 through 2303.28, as a shorthand for the phrase "Requirements for Principal Based Reserves for Life Products" as described in the Valuation Manual. VM-20 is a life insurance reserve standard that is described in the NAIC's Standard Valuation Law, which has been adopted by California in section 10489.1 *et seq.*, and the associated Valuation Manual. By adding the proposed definition as it is found in Model #787 there is no confusion regarding what the term means when it is referenced in sections 2303.23 through 2303.28.

The proposed amendment to add authority citations in section 2303.2 is reasonably necessary to include the citations to the laws that provide the commissioner with the authority to adopt regulations covering the reserve financing transactions to which sections 2303.23 through 2303.28 relate. The remainder of the authority citations remain the same as they are the citations provided to establish the commissioner's authority to adopt or amend regulations relating to licensure, 1011(c) review, and credit for reinsurance. Providing correct authority citations is necessary to provide clarity as to what authority the commissioner is relying on.

The proposed amendment to add reference citations is reasonably necessary to make clear what specific statutes the commissioner is implementing, interpreting, or making specific with these regulations. The additional citations relate specifically to the statutes regarding the reserve financing transactions that sections 2303.23 through 2303.28 relate to. The remainder of the reference citations remain the same as they are the citations relating to licensure, 1011(c) review, and credit for reinsurance.

Amend Section 2303.4
Subdivisions (b)(1) and (b)(2)
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment to subdivision (b)(1) is reasonably necessary because changing section 2303.25(a) to section 2303.22(a) reflects internal renumbering that will occur with the incorporation of Model #787 language into the reinsurance oversight regulations. Form AR-1 will be found in section 2303.22(a) after the regulations are renumbered.

The proposed amendment to subdivision (b)(2) is reasonably necessary because changing section 2303.25(b) to section 2303.22(b) reflects internal renumbering that will occur with the addition of Model #787 language into the reinsurance oversight regulations. Form AR-2 will be found in section 2303.22(b) after the regulations are renumbered.

Subdivision (d)
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct cross-citations. The cross-citation in subdivision (d) is corrected from 2303.22(c) to 2303.21(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Amend Section 2303.5.
Subdivisions (b) and (i)
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct cross-citations. The cross-citation in subdivision (b) is corrected from 2303.22(d) to 2303.21(d). The cross-citation in subdivision (i) is corrected from 2303.22(d) to 2303.21(d). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Subdivisions (b)(6) and (b)(7)
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment to subdivision (b)(6) is reasonably necessary because changing section 2303.25(a) to section 2303.22(a) reflects internal renumbering that will occur with the proposed addition of Model #787 language into the reinsurance oversight regulations. Form AR-1 will be found in section 2303.22(a) after the regulations are renumbered.

The proposed amendment to subdivision (b)(7) is reasonably necessary because changing section 2303.25(b) to section 2303.22(b) reflects internal renumbering that will occur with the proposed addition of Model #787 language into the reinsurance oversight regulations. Form AR-2 will be found in section 2303.22(b) after the regulations are renumbered.

Subdivisions (e)(5)(A)(i)(a) and (e)(5)(A)(i)(b)
The specific purpose of the proposed amendment is make the format of cross-citations in the regulations consistent. The citation format in subdivision (e)(6)(B) reflects Bluebook citation format, therefore the proposed amendment to subdivisions (e)(5)(A)(i)(a) and (e)(5)(A)(i)(b) is reasonably necessary to make all cross-citations consistent with the Bluebook citation format found in subdivision (e)(6)(B). Consistent cross-citation format provides clarity and makes cross citations easier to find.

Subdivision (e)(6)(B)
The specific purpose of the proposed amendment is to change the name of the National

Association of Securities Dealers (NASD) to the Financial Industry Regulatory Authority (FINRA), which it is now known as. In 2007, NASD was merged with FINRA. The addition of the phrase, “or successor organization” is to allow for the possibility of future mergers without having to amend the regulations. The NAIC also made the proposed amendment in the Model Credit for Reinsurance Regulation #786. Including the most current name of the organization prevents confusion regarding what organization the regulation is referencing, which assists with the application of the regulations.

Amend Section 2303.8.

Subdivisions (d) and (f)

The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment in subdivision (d) from 2303.25(d) to 2303.22(d) is reasonably necessary to reflect internal renumbering that will occur with the proposed addition of Model #787 language into the reinsurance oversight regulations. With the proposed additions to the regulations, section 2303.22(d) will have the text of form AR-3 after the regulations are renumbered.

The other proposed amendments are to correct cross-citations in subdivisions (d) and (f). The proposed amendments in subdivisions (d) and (f) are reasonably necessary to correct cross-citations. The amendment in subdivision (d) corrects the cross-citation from section 2303.22(e) to 2303.21(e). The cross-citation in subdivision (f) is corrected from 2303.19(c) to 2303.18(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Amend Section 2303.9.

Subdivision (c)

The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct the incorrect cross-citation in subdivision (c) from 2303.19(c) to 2303.18(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Amend Section 2303.11.

Subdivision (g)

The specific purpose of the proposed amendment is to change the word “should” to “shall”. The proposed amendment is reasonably necessary to make the requirements of subdivision (g) clear. Subdivision (g) is discussing what a ceding insurer’s appointed actuary needs to consider when determining the proper credit to take in financial statements. The subdivision first uses the word shall, meaning that the requirement is mandatory, but then in the second sentence uses the word should, which is not mandatory. Should is not internally consistent with the subdivision, and it creates confusion because it is no longer clear if this requirement is mandatory. Additionally, the maintenance of adequate documentation is essential to determining the proper credit to take in financial statements. Changing should to shall makes the requirements of the subdivision specific and clear, and it better reflects the specific statutes the commissioner is implementing, interpreting, or making specific with these regulations.

<u>Subdivision (*l*)</u>
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct the incorrect cross-citation in subdivision (*l*) from 2303.19(c) to 2303.18(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

<u>Amend Section 2303.12.</u>
<u>Subdivision (b)</u>
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct the incorrect cross-citation in subdivision (b) from 2303.19(c) to 2303.18(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

<u>Amend Section 2303.13.</u>
<u>Subdivision (f)</u>
The specific purpose of the proposed amendment is to reflect changed internal references. The proposed amendment is reasonably necessary to correct the incorrect cross-citation in subdivision (f) from 2303.19(c) to 2303.18(c). As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

<u>Amend Section 2303.14</u>
<u>Subdivision (a)</u>
The specific purpose of the proposed amendment is to remove references to, and requirements for, volume insurers, which is a concept that no longer has context or an explanation in the reinsurance oversight regulations. The proposed amendment to subdivision (a) is reasonably necessary to remove "volume insurer," and make clear that subdivision (a) only relates to contract requirements for domestic insurers.

When the reinsurance oversight regulations were updated in 2015 by the Section 100, to remedy inconsistencies in the regulation text that were superseded by the change to Insurance Code section 922.6 as a result of SB 1216, the references to volume insurers in section 2303.14 could not be updated at that time. Section 100(a)(6) allows for changes to regulations without a formal rulemaking when the change would make the regulation consistent with a changed California statute, and the adopting agency has no discretion to adopt a change that differs in substance from the change chosen. Insurance Code section 922.6 relates specifically to the commissioner's authority to impose financial statement credit for reinsurance. Therefore, throughout the regulations references to the provision of credit for reinsurance for foreign or "volume insurers" were removed, as they were no longer consistent with Insurance Code section 922.6. Additionally, the definition for volume insurer, which was "a foreign insurer whose average gross direct premiums written in California as reported in its three most recent annual statements, or as reported for any lesser period of time if it has been licensed in California only for such lesser period of time, (a) exceeds the average gross direct premiums written in its state of domicile for the same period, and (b) constitutes 33 percent or more of its total gross direct premiums written in the United States for such three year or lesser period," was removed from the regulations. Section 2303.14, however, relates specifically to the commissioner's licensing authority in Insurance Code sections 700 and 717, rather than his accounting credit authority in 922.6. Thus, removing the reference to "volume insurer" from subdivision (a) could not occur with the Section 100, meaning that the term volume insurer remained in this section until the regulations could be amended through a full rulemaking. The proposed change in this rulemaking to remove the term volume insurer reduces confusion because it removes defunct concepts and terms that no longer apply to any insurer.

Additionally, removing the term volume insurer from this section makes the regulations consistent with Bulletin 2011-2. Under section 717(d) of the Insurance Code, which this section of the regulations implements, the commissioner has discretion to find that the insurer's reinsurance arrangements are materially deficient. In Bulletin 2011-2, the commissioner stated that he will not exercise his discretion to make such a finding concerning the reinsurance agreements of a non-domestic insurer. Therefore, the removal of volume insurer is reasonably necessary to reflect the exercise of the commissioner's discretion to not find a foreign insurer's reinsurance contract materially deficient.

Subdivision (c)
The specific purpose of the proposed amendment is to remove references to, and requirements for, volume insurers, which is a concept that no longer has context or an explanation in the reinsurance oversight regulations. This subdivision provides that a volume insurer's reinsurance contract will not be found deficient as to form if it was entered into within a specific time, and it met the requirements of subdivision (b) of this section. Removal of references to a volume insurer is reasonably necessary to prevent confusion in subdivision (c) because volume insurer is a term/concept without context or an explanation in the regulations after the removal of the definition of volume insurer with the Section 100. Additionally, because this subdivision relates specifically to requirements as to the form of a volume insurer's reinsurance contract, removal of this

subdivision will memorialize Bulletin No. 2011-2 and make clear that the commissioner is exercising his regulatory discretion to comply with the requirements of the NRRA. The NRRA provides that the laws of nondomestic states, except those with respect to taxes and assessments, are preempted to the extent they apply to reinsurance agreements. Volume insurers were defined as foreign insurers that did a certain amount of business in California, thus the removal of subdivision (c) makes clear that section 2303.14 will not apply to the reinsurance contracts of foreign insurers.

Because subdivision (c) will be removed, the numbering of the remaining subdivisions within this section of the regulations will need to be changed.

Amend Section 2303.15.

Subdivision (b)

The specific purpose of the proposed amendment is to remove references to, and requirements for, volume insurers, which is a concept that no longer has context or an explanation in the reinsurance oversight regulations. The proposed amendment to subdivision (b) is reasonably necessary to remove volume insurer, and make clear that this subdivision only applies to domestic insurers. Because subdivision (b) relates specifically to requirements to the form of a volume insurer's reinsurance contract, removal of reference to a volume insurer will memorialize Bulletin No. 2011-2 and make clear that the commissioner is exercising his regulatory discretion to comply with the NRRA by not enforcing the laws of California on a foreign insurer to the extent they apply to reinsurance agreements.

The change of the term per line of business to per reinsurance agreement is reasonably necessary to reflect the commissioner's discretion in the application of this subdivision, and will memorialize and make consistent the Department's current practice in interpreting this subdivision. Use of the phrase "per line of business" is confusing in that generally when business is ceded it is ceded as a reinsurance agreement or a block of business that potentially incorporates many lines of business. The application of the 10% retention in subdivision (b) has never been applied to the individual lines of business that a direct writer holds, rather the retention is applied to the reinsurance agreement as a whole, which encompasses specific lines of business. The proposed change does not affect the purpose of the 10% retention, which is to ensure that domestic insurers have a sufficient interest in the underlying business that is written. Sufficient interest in the underlying business written results in adequate pricing, meaningful underwriting guidelines, and even acts as a protection for an insurer entering a new line of business. The change of the phrase "line of business" to "reinsurance agreement" does not change the purpose of the retention because the business written will ultimately be ceded as a reinsurance agreement, which again encompasses specific lines of business. Finally, the proposed change is more specific to better reflect how the regulation, and the discretion in this subdivision has been applied. The application of section 2303.19 discretion on a case by case basis presents the opportunity for inconsistent application, particularly as in the case of subdivision (b) when the terms in the regulation are confusing and fail to reflect the practical application of the regulation.

The removal of the reference to subdivision (g) is reasonably necessary because in Bulletin 2011-2, the commissioner made clear that pursuant to the commissioner's reserved discretion in section 2303.1, the examination filings under subdivision (g) would no longer be required of any insurer.

The other proposed amendment in subdivision (b) corrects the cross-citation from section 2303.22(f) to 2303.21(f). The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

<u>Subdivision (e)</u>
The specific purpose of the proposed amendment is to make clear how insurers can comply with the requirements of Insurance Code section 1011(c). Subdivision (e) relates to California Insurance Code section 1011(c), which gives the commissioner the discretion to conserve any insurer that has entered into certain transactions without obtaining the commissioner's prior consent. The original language of the regulation encompasses both indemnity reinsurance agreements and purchase and sale transactions or assumption reinsurance, and it is applied equally to foreign and domestic insurers, because it uses the term "licensed". The proposed language of the regulation is reasonably necessary to clarify the commissioner's discretion as it relates to Code section 1011(c) in the following ways:

1. It creates a distinction between indemnity reinsurance and assumption reinsurance. Both types of transactions are encompassed by section 1011(c), and the regulation text applies to these transactions in the same way. However, after passage of the NRRA, a distinction must be made between how the commissioner's discretion is applied to these two different transactions; and

2. It makes it clear that for domestic insurers section 1011(c) applies only to indemnity reinsurance, but for assumption reinsurance it applies to licensed insurers, which includes both domestic and foreign insurers.

The proposed amendment does not create new or different requirements for applications subject to 1011(c). Rather, it makes clear that foreign insurers no longer have to file indemnity reinsurance transactions for commissioner approval.

The proposed amendment to remove the term "licensed" and add the term "domestic" is reasonably necessary to reflect Bulletin 2011-2, in which the commissioner made clear that pursuant to the commissioner's reserved discretion in section 2303.1, he will not exercise his discretion to conserve a non-domestic insurer for failure to obtain prior consent to the indemnity reinsurance transactions described in subdivision (c) through original subdivision (f) of section 2303.15. The term licensed includes both foreign and domestic companies. Thus, in order to make it clear which insurers the commissioner's discretion applies to, in the context of indemnity reinsurance agreements referenced in this subdivision, the use of the term domestic is more appropriate.

However, as described in subdivision (d) of this section, the phrase "substantially its entire property or business" found in section 1011(c) of the Insurance Code means, "an amount of business such that the sale, cession, assumption or purchase thereof has the potential to render a company insolvent or create a hazard to its policyholders or creditors." Subdivision (e) refers to subdivision (d), which makes clear that "substantially its entire property or business" in section 1011(c) includes sale or purchase transactions. As defined in subdivision (c), sale or purchase transactions are commonly referred to as "assumption reinsurance," a type of transaction that is not indemnity reinsurance, meaning that while assumption reinsurance is not subject to the NRRA it is still governed by this section. The language the Department is proposing to add makes it clear that assumption reinsurance, as it is defined in subdivision (c)(3), is governed by subdivision (e). The proposed language uses the term licensed, which includes both foreign and domestic companies. It is reasonably necessary to add the term licensed to make it clear that both foreign and domestic insurers will still need to file an application for the commissioner's consent for sale and purchase transactions which are not governed by the NRRA.

Because a distinction needed to be made between indemnity reinsurance transactions and assumption reinsurance transactions it is reasonably necessary to remove the word "such" and add the words "within the scope of subdivision (d) of this section." Previously such included both types of applications, which with the proposed amendment no longer makes sense. Further, the word "such" is vague, and drawing the connection back to the 1011(c) description in subdivision (d) makes the regulation clearer and easier to apply.

Another proposed amendment in subdivision (e) corrects the cross-citation from section 2303.22(g) to 2303.21(g). The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

The last proposed amendment to subdivision (e) is removal of the notice filing requirement for affiliate transactions by licensed insurers exempt from Holding Company Act registration. The proposed amendment to remove this requirement is reasonably necessary because this provision has not been enforced, and it is confusing to keep provisions in the regulations that are not enforced.

<u>Subdivision (f)</u>
The proposed amendment to add subdivision (f) is reasonably necessary to add clarity to the filing requirements that are reflected in section 1215.5(b)(3) of the Insurance Code. Subdivision (e) makes clear that a 1011(c) application related to an indemnity reinsurance transaction would fulfill the filing requirement of Insurance Code section 1215.5(b)(3).

The proposed addition of subdivision (f) is reasonably necessary to make clear that in the event an application doesn't meet the 1011(c) threshold defined in subdivision (d), domestic insurers still need to file indemnity reinsurance agreements meeting the 1215.5(b)(3) threshold. The 1215.5 filing requirement has always been implicit, but in order to provide easier application of the statutory requirements the proposed amendment would make this requirement explicit. The language of proposed subdivision (f) makes clear that this requirement only applies to domestic insurers. Further, the proposed language of subdivision (f) memorializes Bulletin No. 2011-2 and makes clear that the commissioner is exercising his regulatory discretion in section 1215.14(b) of the Insurance Code to exempt commercially domiciled insurers from some or all of the requirements of Article 4.7 of the Insurance Code under circumstances he deems appropriate to comply with the requirements of the NRRA.

<u>Subdivision (g)</u>
The proposed amendment to subdivision (g) (formerly subdivision (f)) to add "affiliate or an" is reasonably necessary to add clarity to the subdivision. An intercompany pool can be reasonably interpreted to be among two or more parties, which would implicitly include cessions to "an affiliate". The proposed amendment, however, would provide additional clarity by making it explicit.

The proposed amendment removes the language that conditions consent of a reinsurance pooling agreement on if the agreement provides at least a 10% retrocession to the cedent. The proposed amendment is reasonably necessary to memorialize Bulletin 2011-2, and to reflect CDI's practice in exercising the commissioner's reserved discretion found in sections 2303.1 and 2303.19. As the regulation is currently written, the specific condition of a 10% retention is confusing because the original language of the regulation makes the retention mandatory – "shall be conditioned upon". Bulletin 2011-2 states that the commissioner will not deny consent for a cession to an admitted affiliate solely on the basis that the agreement does not include a retrocession to or retention by the ceding insurer. The mandatory language is also redundant because a 10% retention can be required in item (2) by the language "or including within the reinsurance agreement provisions that protect the ceding insurer in a manner satisfactory to the Commissioner". The proposed amendment provides clarity because it removes the redundancy and better reflects the commissioner's practice to exercise his discretion to allow a 100% cession without a 10% retention.

The proposed amendment to remove the original subdivision (g) will memorialize Bulletin No. 2011-2 and make clear that the commissioner is exercising his regulatory discretion in section 730 of the Insurance Code. Section 730 of the Insurance Code gives the commissioner the discretion to require an examination of any scope or nature whenever he deems necessary. Subdivision (g) is an expression of the commissioner's section 730 discretion, and requires certain licensees to submit for prior review certain reinsurance transactions that comprise 50% or more of the licensee's premium or liabilities. Bulletin 2011-2, however, exercised the commissioner's discretion in section 2303.1 to no longer require examination filings under subdivision (g) from any insurer. Removing this requirement from the regulations makes filing requirements for companies clear, and removes this provision from the regulations which will no longer be enforced.

Subdivision (h)
The proposed amendment to subdivision (h) is reasonably necessary to remove the reference to the subdivision (g) examination filings that will no longer be required of any insurer. Removing internal cross-references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

The proposed amendment to remove the definition of "liabilities" in subdivision (h)(3) is reasonably necessary because it is inconsistent with the "total liabilities" definition above. Total liabilities in subdivision (h)(2)(B)(iv) are liabilities for policy and contract claims, which would be reported on a gross basis. In subdivision (h)(3) "liabilities" include reserves for reinsurance assumed and ceded, which is reported on a net basis. This inconsistency creates confusion and does not make sense. Thus, in order to provide clarity it is reasonable to remove this inconsistent definition.

Subdivision (i)
The proposed amendment to subdivision (i) is reasonably necessary to remove the term, and thus the requirements for, volume insurers. The concept of a volume insurer no longer exists in the reinsurance oversight regulations because of SB 1216 and the subsequently filed Section 100. Removal of the reference to a volume insurer is reasonably necessary to make clear who the regulations apply to.

Subdivision (i) also implements section 717(d) of the Insurance Code and gives the commissioner discretion to require contract provisions to protect the cedent when specific collateral is not required for agreements filed pursuant to subdivisions (e) and (g). Subdivision (e) relates to California Insurance Code section 1011(c), which gives the commissioner the discretion to conserve any insurer that has entered into certain reinsurance transactions without obtaining the commissioner's prior consent. The proposed amendment to remove reference to a volume insurer is reasonably necessary to reflect Bulletin 2011-2, in which the commissioner made clear that pursuant to the commissioner's discretion in section 2303.1, he will not exercise his discretion to conserve a non-domestic insurer for failure to obtain prior consent to the reinsurance transactions described in subdivisions (c) through original (f) of this section.

The proposed amendment to remove the reference to subdivision (g) is reasonably necessary as the subdivision (g) examination filings will no longer be required of any insurer. Removing internal cross-references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

Subdivision (j)
The proposed amendment to subdivision (j) is reasonably necessary to remove the term, and thus the requirements for, volume insurers. The concept of a volume insurer no longer exists in the reinsurance oversight regulations because of SB 1216 and the subsequently filed Section 100 application. Removal of the reference to a volume insurer is reasonably necessary to make clear who the regulations apply to.

Subdivision (j) also implements section 1011(c) of the Insurance Code and states conditions for the commissioner's consent to agreements filed under subdivisions (e) and (g) when payments are to be made through a reinsurance intermediary. Subdivision (e) relates to California Insurance Code section 1011(c), which gives the commissioner the discretion to conserve any insurer that has entered into certain reinsurance transactions without obtaining the commissioner's prior consent. The proposed amendment to remove reference to a volume insurer is reasonably necessary to reflect Bulletin 2011-2, in which the commissioner made clear that pursuant to the commissioner's discretion in section 2303.1, he will not exercise his discretion to conserve a non-domestic insurer for failure to obtain prior consent to the reinsurance transactions described in subdivisions (c) through original (f) of this section.

The proposed amendment in subdivision (j)(1), to remove the reference to subdivision (g), is reasonably necessary as the subdivision (g) examination filings will no longer be required of any insurer. Removing internal cross-references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

The proposed amendment in subdivision (j)(1) also corrects the cross-citation from section 2303.17(c) to 2303.16(c). The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Prior to the Section 100, the provisions of the regulations that governed reinsurance intermediaries were found in section 2303.17. After the Section 100, the provisions governing reinsurance intermediaries are in section 2303.16. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

<u>Subdivision (l)</u>

The proposed amendment in subdivision (l), to remove the reference to subdivision (g), is reasonably necessary as the subdivision (g) examination filings will no longer be required of any insurer. Removing internal cross-references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

<u>Subdivision (m)</u>

The proposed amendment in subdivision (m) corrects the cross-citation from section 2303.22(k) to 2303.21(k). The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

The proposed amendment in subdivision (m), to remove the reference to subdivision (g), is reasonably necessary as the subdivision (g) examination filings will no longer be required of any insurer. The proposed amendment would remove all of the language that explains that "non-objection" would include transactions filed pursuant to subdivision (g) of this section. Removing internal cross-references, and explanations that relate to those references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

Subdivision (o)
The proposed amendment in subdivision (o), to remove the reference to subdivision (g), is reasonably necessary as the subdivision (g) examination filings will no longer be required of any insurer. Removing internal cross-references that are no longer necessary or correct provides clarity regarding regulatory requirements, and makes application of the regulations easier.

Subdivision (q)
The proposed amendment in subdivision (q)(2) corrects the cross-citation from section 2303.22(i) to 2303.21(i). The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Amend Section 2303.17
The proposed amendment to the authority citations in section 2303.17 is reasonably necessary to provide a correct authority citation for the regulations. The citation to section 1011 of the Insurance Code should be to section 1011.5 of the Insurance Code. The citation to 1011 is a typo and should be corrected so it is clear what authority applies to this section of the regulations.

Amend Section 2303.19
The proposed amendment to section 2303.19, to add the language "Sections 2303.1 through 2303.22 of," is reasonably necessary to make clear that the commissioner's discretion, existing in the regulations prior to the amendments being proposed by this rulemaking, relates only to specific sections of the regulations. Sections 2303.1 through 2303.22 encompass the original requirements in the reinsurance oversight regulations, and in these requirements the commissioner's discretion plays an important role. For example, the commissioner's discretion is applied in the review and oversight of reinsurance transactions, in the review and requirements relating to specific types of reinsurers and collateral, and in the commissioner's licensing and examination authority, among other things.

The concept of the commissioner's discretion to not require strict compliance with sections 2303.23 through 2303.28 is contrary to the intent and purpose of the proposed new sections regarding reserve financing transactions. The intent and purpose of sections 2303.23 through 2303.28 is to create uniform, national standards governing reserve financing arrangements and to ensure that, with respect to each such financing arrangement, funds consisting of specific security in required forms and amounts are held by or on behalf of ceding insurers. Therefore, the proposed amendment is reasonably necessary to make specific which provisions of the regulations the commissioner's discretion applies to, and the language of the proposed addition makes it clear under which sections the commissioner can exercise discretion.

Amend Section 2303.21

Subdivision (a)

The proposed amendment to change days to days' is reasonably necessary to make the grammar in the regulations correct.

Subdivision (f)

The proposed amendment to subdivision (f) to remove "line of business" and add "reinsurance agreement" is reasonably necessary to reflect the proposed amendment in section 2303.15(b). As discussed in 2303.15(b), changing "line of business" to "reinsurance agreement" is reasonably necessary to better reflect the way the commissioner exercises his discretion in applying section 2303.15(b), while still ensuring that the protective purpose of the retention is achieved.

Subdivision (g)

The proposed amendment to subdivision (g), to add reference to a sale and purchase transaction, is reasonably necessary to make the filing requirements clear. As described in the discussion of the amendment to Section 2303.15(e), the subdivision did not draw a distinction between indemnity reinsurance agreements and assumption reinsurance agreements. The language in this section did not make a distinction between these two types of transactions either. Therefore, in order to provide more clarity in the regulations regarding filing requirements for these different types of transactions, the proposed amendment in this subdivision will make the distinction between indemnity reinsurance and assumption reinsurance transactions clear. By connecting the concepts in the filing requirements with the concepts in the sections of the regulations the proposed amendment brings additional continuity to the regulation text.

Subdivision (h)

The proposed amendment to remove subdivision (h) is reasonably necessary to reflect the proposed amendment to remove 2303.15(g). The proposed amendment to remove the original subdivision (g) removes the requirement for licensees to file reinsurance transactions that comprise 50% or more of the licensee's premium or liabilities. The removal of this examination requirement will memorialize Bulletin No. 2011-2 and make clear that the commissioner is exercising his regulatory discretion in section 730 of the Insurance Code and section 2303.1 of these regulations to no longer require examination filings under subdivision (g) from any insurer.

The proposed addition of new subdivision (h) is reasonably necessary to provide guidance to applicants regarding how to file certified reinsurer applications, as described in section 922.41 of the Insurance Code. The addition of subdivision (h) provides clarity for applicants seeking certified reinsurer status in California because it directs them how to file the application.

Subdivision (j)
The proposed amendment in subdivision (j) corrects the cross-citation from section 2303.17 to 2303.16. The proposed amendment is reasonably necessary to correct cross-citations. As a result of the Section 100, which was necessitated to conform the regulation text to changes in the Insurance Code as a result of SB 1216, the regulations were renumbered. Many of the cross-citations that changed as a result of the renumbering were included in the Section 100, but some were overlooked. In order to prevent confusion and provide clarity regarding legal requirements, CDI would like to correct cross-citations in this rulemaking.

Subdivision (k)
The proposed amendment in subdivision (k) to change CDI's Corporate Affairs Bureau's name is reasonably necessary to reflect the current name of the bureau. The name of the bureau was changed in the Section 100 to Corporate & Regulatory Affairs Branch, which was the name of the bureau at the time the Section 100 was made. Subsequent reorganization of CDI's legal division resulted in the change of the bureau's name to Corporate Affairs Branch. In order to provide consistency and clarity for applicants, it is reasonably necessary to change the name of the bureau to Corporate Affairs Branch with this rulemaking.

Subdivision (l)
The proposed addition of subdivision (l) is reasonably necessary to provide applicants with information regarding how to file the notification required by section 922.31 of the Insurance Code. SB 1216 included a requirement for domestic cedents to provide notice to the commissioner regarding their concentration and diversification of risk with a single assuming insurer, or group of affiliated assuming insurers. Providing the proposed filing requirement in this subdivision makes the requirement for how notice can be provided to the commissioner specific and clear.

Renumber Sections 2303.22 and 2303.23.
The proposed amendment to renumber sections 2303.22 and 2303.23 is reasonably necessary to provide a logical flow without unnecessary duplication in the regulatory scheme with the proposed addition of the new sections relating to reserve financing transactions.

Renumber Section 2303.24 to Section 2303.22.
The proposed amendment is to renumber section 2303.24 to 2303.22. The proposed amendment to renumber is reasonably necessary because sections 2303.22 and 2303.23 have been proposed to be moved and renumbered to provide a logical flow and prevent unnecessary duplication in the regulations. When sections 2303.22 and 2303.23 have been moved it will result in the renumbering of section 2303.24 to 2303.22.

Adopt Section 2303.23 through 2303.28.
Section 922.85 of the Insurance Code provides the commissioner with broad rulemaking authority to adopt regulations or prescribe requirements consistent with sections 922.4 and 922.5 of the Insurance Code. Sections 922.4 and 922.5 specifically state when credit for reinsurance will be allowed to a domestic cedent as either an asset or deduction from liability on account of the reinsurance ceded when the reinsurer meets specific requirements. It is reasonably necessary to include sections 2303.23 through 2303.28 in the Reinsurance Oversight Regulations because these sections address when credit for reinsurance will be provided to California domiciled life insurers for reinsurance treaties that cede liabilities pertaining to non-grandfathered life insurance policies with guaranteed non-level gross premiums and/or guaranteed non-level benefits, also known as "Covered Policies". Sections 2303.23 through 2303.28 continue the stated purpose of section 2303, which is to establish, "the principal requirements of substance and procedure in accounting for reinsurance on insurer financial statements, the general requirements applicable to reinsurance agreements, and related sanctions and oversight" by establishing a uniform framework for the evaluation and regulation of these transactions. By establishing a uniform framework in California law of standards that govern reserve financing transactions, the regulations determine how credit for reinsurance can be provided for the liabilities ceded in the course of these arrangements.

The proposed addition of sections 2303.23 through 2303.28 is reasonably necessary for California to comply with anticipated NAIC accreditation standards. The proposed text of sections 2303.23 through 2303.28 is an adoption of NAIC Model #787, which is anticipated to become an accreditation standard as early as January 1, 2020. The NAIC's Reinsurance Task Force made a recommendation to the Financial Regulation Standards and Accreditation (F) Committee (F Committee) to expedite the process of making Model #787 an accreditation standard. If the F Committee does not accept the recommendation to expedite the process, Model #787 is anticipated to become an accreditation standard by January 1, 2022. The proposed adoption of Model #787 text, with a few non-substantive deviations for grammatical clarity, or to comply with California methods of citation, is to assure that California will meet any accreditation requirement based on the Model.

Adopt Section 2303.23.
The specific purpose of the proposed addition of section 2303.23 is to not only make the intent of the regulations clear, but to provide context for the regulation sections that follow. Section 2303.23 begins by making the intent of the regulations that follow clear by directly stating that the intended purpose of the regulatory scheme is to establish uniform standards to govern reserve financing transactions used for life insurance policies with guaranteed nonlevel gross premiums, guaranteed nonlevel benefits, and universal life insurance policies with secondary guarantees, and ensure that security is held in the forms and amounts required. By defining the types of policies impacted by the regulations, life insurance policies with guaranteed nonlevel gross premiums, guaranteed nonlevel benefits, and universal life insurance policies with secondary guarantees, it is clear that these regulations will only address these specific types of policies.

The section also establishes that it intends to establish uniform, national standards governing reserve financing transactions that with respect to each arrangement there will be funds held as either Primary or Other Security. This statement lays the groundwork for the scheme that follows, which makes clear that specific forms of security must be held by or on behalf of the cedent on a treaty by treaty basis in order to comply with the requirements of the regulations. By making clear the types of securities acceptable the application of the regulation can be consistent. Additionally, in establishing uniform standards regarding the type of security needed, the regulations can establish appropriate protections to address the concern that reserves will not be available to pay claims when needed.

This section also makes clear that the intent of the regulatory scheme that follows is to create uniform standards to ensure that all reserve financing transactions are regulated in the same manner, with the same standards and requirements, for all companies. Uniformity is necessary to address the harm created by reserve financing transactions with specific types of entities such as captive insurers, special purpose vehicles, reinsurers that are not eligible to be certified reinsurers, or reinsurers that materially deviate from statutory accounting and/or RBC rules. As there was inconsistent regulation of the transactions based on different captive laws among the states, and a lack of transparency in financial statement reporting requirements for these types of entities, establishing clear, uniform requirements reduces confusion regarding what is expected and how to comply with regulatory requirements, as well as ensuring consistent application and reporting among states.

The section also provides an example of some characteristics of reinsurance ceded for reserve financing purposes. In providing characteristics of the reinsurance agreements that created the harm the regulations are addressing, the section is providing context for the regulatory scheme that follows. In the examples provided, the assets used to secure the reinsurance treaty or capitalize the reinsurer are assets that are issued by the cedent, are not unconditionally available for the payment of claims, or create an obligation on the part of the cedent. These characteristics continue the obligations of the cedent and do not reflect a true risk transfer, which is an essential component of an indemnity reinsurance transaction.

In making the intent of the regulations clear the section also lays the groundwork for the regulation sections that follow by generally describing the types of policies impacted by these sections, the types of security required, and the general characteristics of reinsurance ceded for reserve financing purposes. The addition of section 2303.23 to the reinsurance oversight regulations is reasonably necessary because in setting the parameters of the regulatory scheme, it makes clear the problem the regulatory scheme is addressing, and who needs to comply with these sections.

Adopt Section 2303.24.

The specific purpose of the proposed addition is to describe the applicability of sections 2303.23 through 2303.28. Section 2303.24 makes clear that sections 2303.23 through 2303.28 apply to reinsurance treaties that cede specifically defined policies, Covered Policies, issued by life insurance companies domiciled in California. It is reasonably necessary to describe the companies impacted by the regulation – life insurance companies – because the regulations are intended to address specific transactions undertaken by these specific companies. It is reasonably necessary to describe that the companies impacted by the regulation are life insurance companies domiciled in California. Defining the companies makes it clear who the regulations apply to.

Section 2303.24 also describes what provisions of the reinsurance oversight regulations apply to the specific reinsurance treaties defined in the section if there is conflict between the requirements in sections 2303.23 through 2303.28 and sections 2303.1 through 2303.22. The addition is reasonably necessary to make clear how the sections of the reinsurance oversight regulations will apply to the reinsurance treaties addressed by these regulations. Making it clear how the law applies promotes transparency of the regulatory scheme and makes the law easier to apply.

Adopt Section 2303.25.
The specific purpose of the proposed addition of section 2303.25 is to provide exemptions to the regulatory scheme established in sections 2303.23 through 2303.28. It is reasonably necessary to determine exemptions to the regulatory scheme established in sections 2303.23 through 2303.28 because the intent of the regulations is to address specific transactions. The exemptions prevent the regulations from being over inclusive or burdensome by exempting reinsurance of specific types of policies or reinsurance ceded to a specific type of reinsurer. By making clear what policies or cessions to a specific reinsurer are governed by the regulations it is easier to apply the regulation uniformly. Additionally, it is easier for regulated entities to know what transactions are subject to the regulatory scheme.

Subdivision (a)
The subdivision is reasonably necessary to describe the types of policies that will not be subject to sections 2303.23 through 2303.28.

Subdivision (b)
The subdivision is reasonably necessary to make clear that the requirements of sections 2303.23 through 2303.28 will not apply if the assuming insurer collateralizes its reinsurance obligations with a multibeneficiary trust and the reinsurer meets the applicable requirements of section 922.4(d) of the Insurance Code.

Subdivision (c)
The subdivision is reasonably necessary to make clear that the requirements of sections 2303.23 through 2303.28 will not apply if the reinsurer is licensed or accredited in California and prepares its statutory financial statements in compliance with the NAIC Accounting Practices and Procedures manual, without any departure from statutory accounting practices. Additionally, the reinsurer must not be in any of the defined risk-based capital events to meet this exemption.

Subdivision (d)
The subdivision is reasonably necessary to make clear that the requirements of sections 2303.23 through 2303.28 will not apply if the reinsurer is licensed or accredited in

California and is not affiliated with the cedent or any other insurer that ceded business to the cedent. The subdivision clarifies that in order to qualify for this exemption the reinsurer's statutory financial statements have to be in compliance with the NAIC Accounting Practices and Procedures manual; the reinsurer must be licensed or accredited, but not as a captive, in at least 10 states; and the reinsurer does not have an RBC level below 500% of the Authorized Control Level RBC, without any permitted practices.

Subdivision (e)
The subdivision is reasonably necessary to make clear that the requirements of sections 2303.23 through 2303.28 will not apply if the reinsurer meets the requirements of Insurance Code section 922.85(b)(4)(A) for certification, or maintains certain threshold size and licensing requirements as defined in section 922.85(b)(4)(B) of the Insurance Code.

Subdivision (f)
The subdivision is reasonably necessary to provide the commissioner discretion to allow an exemption if the reinsurance transaction doesn't meet an exemption under subdivisions (a) through (e) of this section. The commissioner's discretion in this subdivision was added to address the possibility of unforeseen or unique transactions that should qualify for an exemption from this regulatory scheme, but were not foreseen in the drafting process. The NAIC, when drafting the Model that sections 2303.23 through 2303.28 are based on, recognized that it is impossible to foresee every type of reinsurance transaction, and that in rare instances unanticipated transactions may be subject to this regulation purely as a technicality. In the situation when a transaction is subject to these sections as a technicality, regulatory relief may be appropriate. This exemption should not be used with respect to "normal course" reinsurance transactions, rather normal course transactions should either fit in one of the standard exemptions set forth in Section 2303.25 or meet the substantive requirements of these regulations. Providing the commissioner discretion assists with the application of the regulations in that it ensures the regulations will be applied to transactions in a manner to achieve the intent and purpose of the regulatory scheme.

Adopt Section 2303.26.
The specific purpose of the proposed addition of section 2303.26 is to provide an explanation of what actuarial method will be applied and how it will be applied to determine the required level of primary security necessary for each reinsurance treaty. It is reasonably necessary to detail the method for determining primary security because it increases transparency, as it will be clear to all companies how the level of primary security will be determined. When requirements are defined and clear it also increases uniformity of application.

Subdivision (a)
The subdivision is reasonably necessary to establish clarity regarding how the actuarial method that governs Covered Policies, as defined in section 2303.2(i) of the regulations, will be applied to each reinsurance treaty subject to sections 2303.23 through 2303.28. The actuarial method will be VM-20, which establishes requirements for principle based

reserving for life products, and includes all definitions established in the Valuation Manual as then in effect.

The Valuation Manual "as then in effect" is a concept that will be clear to the actuaries familiar with the Standard Valuation Law (SVL) and the Valuation Manual. The SVL, which is based on NAIC Model Law #820 and included in section 10489.1 *et seq.*, specifically section 10489.96(b)(1) of the Insurance Code, establishes that the operative date of any changes to the Valuation Manual is January 1 after three-fourths of the voting members of the NAIC have adopted the change. So in sections 2303.23 through 2303.28 the Valuation Manual that will always be applied is the Valuation Manual that meets the criteria detailed in section 10489.96(b). The adoption of the Valuation Manual functions in a way that is similar to the adoption of the NAIC's *Accounting Practices and Procedures Manual* (AP&P). The AP&P becomes effective in many states without a separate regulatory process. Like the AP&P, the language of section 10489.96(b)(1) allows the Valuation Manual to become effective without affirmative regualtory action – that by virtue of the criteria established in the statue occurring the Valuation Manual is adopted. The reason it is desirable for adoption of the Valuation Manual in this manner without a separate regulatory process is that, like the AP&P it is a highly technical document, which is intended to be published each calendar year, and this adoption by reference in section 10489.96 ensures that the Valuation Manual will always achieve uniformity of reserve standards with the most current version of the Valuation Manual. Additionally, in the Introduction to the Valuation Manual, on page two, there is a description of the Process for Updating the Valuation Manual, so it is obvious what is meant by the phrase Valuation Manual as then in effect.

In subdivision (a)(1), the proposed regulation states that "the Actuarial Method is the greater of the Deterministic Reserve or the Net Premium Reserve." This statement must be read with the definition of Actuarial Method, which as discussed above is defined as a methodology used to determine the Required Level of Primary Security. In subdivision (a)(1), the use of the term Actuarial Method is a condensed way of stating that the result of the entire process of determining what the Required Level of Primary Security is the greater of the Deterministic Reserve or the Net Premium Reserve. California's proposed text is consistent with Model #787.

The subdivision details what the Actuarial Method is based on the type of Covered Policy as defined in section 2303.2(i)(1) or (2). The subdivision notes that if 100% of risk is ceded then the method will be applied on a gross basis, and if the reinsurance treaty cedes less than 100% of the risk with respect to Covered Policies, the Required Level of Primary Security can be reduced. Any adjustments to the Required Level of Primary Security will occur in the sequence that accurately reflects the portion of the risk ceded via the treaty. The regulations make clear that if the cedent cedes risks on Covered Policies in more than one reinsurance agreement, the aggregate Required Level of Primary Security for each of those reinsurance treaties cannot be less than what the Required Level of Primary Security would have been if the risk would have been ceded in a single treaty. The subdivision also discusses how credit for ceded reserves will be determined if a reinsurance treaty cedes risk on both Covered and Non-Covered Policies.

Establishing a clear method ensures the consistent application of the actuarial method to reinsurance treaties subject to this regulatory scheme.

Subdivision (b)
The subdivision is reasonably necessary to provide clarity regarding how the Required Level of Primary Security will be calculated pursuant to the Actuarial Method to determine the amount of Primary and Other Security that is held by or on behalf of the ceding insurer. The subdivision describes that assets that would be admitted under the NAIC AP&P, if held in the cedent's general account without any prescribed or permitted practices, will be valued according to statutory accounting procedures. The value of all other assets held by the cedent will be determined by the values assigned to the assets for the purpose of determining the amount of reserve credit taken, in a manner consistent with VM-20. Establishing a clear method ensures the consistent calculation of the Required Level of Primary Security and the amount of Primary and Other Security that should be held.

Adopt Section 2303.27.
The specific purpose of the proposed addition of section 2303.27 is to establish requirements for how covered policies can obtain credit for reinsurance for ceded liabilities. The section also details how the cedent can remediate a deficiency in security held. Section 922.85 grants the commissioner the authority to adopt regulations relating to the circumstances pursuant to which credit will be reduced or eliminated, therefore it is reasonably necessary for section 2303.27 to make specific the steps a cedent must take for credit to be allowed. One of the concerns with reserve financing transactions was that credit for reinsurance was allowed when ceded reserves were not backed with appropriate assets. Section 2303.27 establishes a procedure to ensure that reserves are established, and backed by appropriate assets, prior to allowing credit for the reinsurance ceded. The details of remediation are reasonably necessary for providing transparency to companies regarding what is expected in order to comply with regulatory requirements. Detailing when credit for reinsurance is allowed and how deficiencies in security can be remediated so credit can be claimed is reasonably necessary to promote the uniform application of the law among all domestic life insurers.

Subdivision (a)
The subdivision is reasonably necessary to establish when credit for reinsurance will be allowed for liabilities ceded under covered policies if all the requirements are met for each treaty. In order to address the harm caused by reserve financing transactions it was determined that it was necessary to apply the rules on a treaty by treaty basis because that is how reserves are ceded in reinsurance agreements, based on the parameters of each reinsurance treaty at issue.

Subdivision (a)(1) makes clear that in order for credit to be claimed for cessions under Covered Policies: the cedent's statutory policy reserves for the covered policies must be established in full pursuant to the Standard Valuation Law (Code Section 10489.1 *et seq.*), and that the credit claimed for the treaty does not exceed the reserves ceded under the contract. This requirement is reasonably necessary because in order to keep the balance between the cession, the credit, and the new business a cedent could write, the credit allowed cannot exceed the reserves that were actually ceded in order to ensure that ceded obligations would be provided for at a later date if necessary.

In subdivision (a)(2) the ceding insurer must determine the Required Level of Primary Security for each treaty and provide support for its calculation. The proposed regulations in sections 2303.23 through 2303.28 detail how the cedent can determine the Required Level of Primary Security. It is reasonably necessary for the cedent to make the determination of the required level of primary security required for each treaty because it is the cedent that is claiming the credit for those cessions on their annual statement.

In subdivisions (a)(3) and (a)(4) funds consisting of Primary Security, and to the extent that funds are not held as Primary Security but as Other Security must be held by or on behalf of the cedent as funds are held pursuant to section 922.5 of the Insurance Code. It is reasonably necessary that the funds would be held by or on behalf of the cedent as this is common in reinsurance arrangements, as discussed in section 922.5 of the Code.

In subdivision (a)(5), if a trust is used to hold funds, the trust must meet the requirements established in section 2303.7 of the regulations with specific exceptions. It is reasonably necessary to cite to section 2303.7 because this section establishes the requirements for when credit will be allowed a domestic cedent for reinsurance ceded when funds are held in a single beneficiary trust held for the exclusive benefit of the cedent as security for the payment of obligations under the reinsurance arrangement. Holding funds for the exclusive benefit of the cedent is an important concept because it is a way to assure that the funds will be available for the cedent when they are needed. The exemptions to section 2303.7 are necessary in order to make a single beneficiary trust held by or on behalf of the cedent make sense in the context of sections 2303.23 through 2303.26. For example, funds consisting of Primary or Other Security that are held in the trust must be valued according to the valuation rules set forth in section 2303.26 of these regulations. In order for the security to meet the goals of the regulation it makes sense that it would be valued in the way that the regulation has established. Affiliate investment limitations with respect to security held in the trust is not a problem if the security is not held to satisfy the Primary Security requirements of the regulations. In order to meet the goal of the regulation to ensure that appropriate types of security is held it makes sense that affiliate investments would not be used to meet the Primary Security requirements. The reinsurance treaty must prohibit withdrawals or substitutions that would leave the fair market value of the trust below 102% of the required level is necessary because this ensures that the security will be available for the cedent when it is needed to pay claims. Finally, in order to maintain consistency with the regulatory scheme established to address reserve financing transactions it makes sense that the determination of reserve credit would be determined based on the valuation rules set forth in section 2303.26.

Finally, subdivision (a)(5) requires that the reinsurance treaty has been approved by the commissioner. It is reasonably necessary to require commissioner approval of the reinsurance treaty as this is a common requirement for affiliated reinsurance transactions.

The subdivision provides clarity for applicants and regulators regarding when credit for reinsurance will be granted for treaties subject to sections 2303.23 through 2303.28. The clarity provided by the requirements established in this subdivision makes application of the regulation easier and more consistent.

<u>Subdivision (b)</u>
The subdivision is reasonably necessary to establish how and when to remediate a shortfall in Primary Security. The establishment of the these provisions is necessary to provide clarity as to how companies can account for and remediate deficiencies in Primary Security in order to claim appropriate credit for reinsurance on financial statements. The clarity of these provisions make the application of the regulation easier and more consistent.

Subdivision (b)(1) requires that on the date that the Covered Policies are ceded, and on an ongoing basis thereafter, the statutory policy reserves are established in full and the appropriate funds are being held by or on behalf of the cedent in a manner that comports with section 922.5 or in a single beneficiary trust as detailed in subdivision (a)(5). The subdivision makes clear that under no circumstances can the cedent consent to take any actions that would result in a deficiency of Primary or Other Security. This requirement is reasonably necessary to ensure that the appropriate securities are being held by or on behalf of the cedent when claims are made. The subdivision requires the cedent to use its best efforts to expediently rectify a deficiency in Primary or Other Security if one exists. The requirement to use best efforts to remediate a deficiency is important to ensure that the proper amount of security is being held for the ceded liabilities. Holding sufficient security to pay on reinsurance obligations is an essential piece to indemnifying the cedent under the reinsurance contract.

Subdivision (b)(2) requires that each life insurance company that has ceded risks within the scope of section 2303.24 has performed an analysis on a treaty-by-treaty basis to determine if at the end of the quarter there is the required amount of Primary or Other Security for the Covered Policies ceded. It is reasonably necessary to require review quarterly to ensure frequent evaluation of the reinsurance transactions to prevent shortfalls in required security and increased financial stability. The regulation requires the cedent to establish a liability equal to the excess of the credit for reinsurance taken over the amount of Primary Security actually held unless the shortfall can be remediated. It is reasonably necessary to only allow credit for reinsurance only up to the amount of Primary Security held because this ensures that cedents are not able to take credit when there are not appropriate assets backing the liabilities ceded. Remediation can occur if funds consisting of Primary or Other Security in an amount at least equal to the Required Level of Primary Security are held by or on behalf of the cedent as of the valuation date, or if the deficiency is eliminated by adding Primary or Other Security prior to the due date of the quarterly or annual statement. During the NAIC drafting process this provision was discussed at length, and many alternatives were considered. This provision was chosen as a balanced solution that allowed regulators with a framework to protect the solvency of companies and groups in the context of these transactions, and as a workable alternative for companies when a shortfall is discovered.

Subdivision (b)(3) makes clear that subdivision (b)(2) is not permitting a company to maintain a deficiency of Primary or Other Security longer than it is necessary to cure it.

It is reasonably necessary to add this subdivision because it makes clear what the intent of the subdivision is.

Adopt Section 2303.28.

The specific purpose of the proposed addition of the section is to make clear that actions that are taken in order to avoid the requirements of the regulation are not preferred. The Insurance Code establishes a framework for when credit for reinsurance is allowed a domestic ceding insurer as an asset or deduction from liability on account of reinsurance ceded. The addition of sections 2303.23 through 2303.28 into the reinsurance oversight regulations makes specific when credit will be allowed for reinsurance relating to Covered Policies through establishing the requirements relating to the valuation of assets or reserve credits, the amounts and forms of security necessary, and the circumstances pursuant to which credit will be reduced or eliminated for reinsurance ceded. Making the prohibition against avoidance of the regulatory scheme explicit is reasonably necessary because it establishes clear expectations regarding the application of the regulatory scheme to Covered Policies.

Renumber and Amend Section 2303.29.

The proposed amendment to renumber section 2303.22 to 2303.29 is reasonably necessary to provide a logical flow to the regulations, without unnecessary duplication in the regulatory scheme. The language of section 2303.29 is the language from the original reinsurance oversight regulations, thus no changes to the current language of the regulations is being proposed. The proposed amendment is to move the section because the proposed adoption of the new sections relating to reserve financing transactions found in sections 2303.23 through 2303.28 also need a severability clause. Moving the original severability clause to section 2303.29 prevents unnecessary duplication of a severability clause in the regulatory scheme.

The proposed amendment to add authority citations is reasonably necessary to include the citations to the laws that provide the commissioner with the authority to adopt regulations that relate to the reserve financing transactions that sections 2303.23 through 2303.28 relate to. The remainder of the authority citations remain the same as they were the citations provided to establish the commissioner's authority to adopt or amend regulations relating to licensure, 1011(c) review, and credit for reinsurance as detailed in sections 2303.1 through 2303.22. Providing correct authority citations is necessary to provide clarity as to what authority the commissioner is relying on.

The proposed amendment to add reference citations is reasonably necessary to make clear what specific statutes the commissioner is implementing, interpreting, or making specific with these regulations. The additional citations relate specifically to the statutes regarding the reserve financing transactions that sections 2303.23 through 2303.28 relate to. The remainder of the reference citations remain the same as they were the citations relating to licensure, 1011(c) review, and credit for reinsurance as detailed in sections 2303.1 through 2303.22.

<u>Renumber and Amend Section 2303.30.</u>
The specific purpose of the proposed amendment to renumber section 2303.23 to 2303.30 is to provide a logical flow to the regulations, without unnecessary duplication in the regulatory scheme. The language of section 2303.30 is the language from the original reinsurance oversight regulations, with a few minor amendments which are discussed below. The proposed amendment to move the section is reasonably necessary to prevent confusion because the proposed adoption of the new sections relating to reserve financing transactions, found in sections 2303.23 through 2303.28, also need an effective date section. Moving the original effective date to section 2303.30 prevents confusion because it continues the logical flow of the regulatory scheme, where the effective date often comes at the end of the regulations. By moving the section and combining the effective date for sections 2303.1 through 2303.22 with the effective date for 2303.23 through 2303.28 the proposal prevents unnecessary duplication and the potential misapplication of when the specific sections become effective.

<u>Subdivision (a)</u>
The proposal to remove subdivision (a) is reasonably necessary to prevent confusion. Subdivision (a) is no longer necessary for the functioning, and interpretation of the reinsurance oversight regulations. When subdivision (a) was initially drafted when the reinsurance oversight regulations became operative in 2006 there were two regulatory schemes in force, the reinsurance oversight regulations and Bulletin 97-5, so subdivision (a) was necessary to establish an effective date of the regulations. The changes being proposed to sections 2303 through 2303.22, in particular cannot be imposed retroactively to reinsurance arrangements, and the proposed additions of sections 2303.23 through 2303.28 were not contemplated when subdivision (a) became operative. Therefore, the proposed removal of subdivision (a) will not change how reinsurance agreements were accounted for prior to January 1, 2007.

<u>Subdivision (b), amended to Subdivision (a)</u>
The proposal to remove "Effective Date" is reasonably necessary because it no longer makes sense with the removal of Subdivision (a), which defined "Effective Date". Once Subdivision (a) is removed, for the reasons described above, there is no context for what "Effective Date" means. When the proposed rulemaking becomes effective the effective date will be the effective date of this section of the regulations for new and renewal agreements, which is reflected in the proposed language. Removal of defined terms without a definition is reasonably necessary to prevent confusion in application of the regulations.

<u>Subdivision (c), amended to Subdivision (b)</u>
The proposal to remove "Effective Date" is reasonably necessary because it no longer makes sense with the removal of Subdivision (a), which defined "Effective Date". Once Subdivision (a) is removed, for the reasons described above, there is no context for what "Effective Date" means. Removal of defined terms without a definition is reasonably necessary to prevent confusion in application of the regulations. The proposal to add January 1, 2007 reflects the important timeframe in Subdivision (a) to make clear that reinsurance agreements executed prior to that time will remain subject to the requirements of Bulletin 97-5.

Subdivision (d), amended to Subdivision (c)
The proposal to remove “Effective Date” is reasonably necessary because it no longer makes sense with the removal of Subdivision (a), which defined “Effective Date”. Once Subdivision (a) is removed, for the reasons described above, there is no context for what “Effective Date” means. When the proposed rulemaking becomes effective the effective date will be the effective date of this section of the regulations, which is reflected in the proposed language. Removal of defined terms without a definition is reasonably necessary to prevent confusion in application of the regulations.

Subdivision (d)
The proposed amendment to add subdivision (d) is reasonably necessary to make clear when, and provide notice regarding the time within which, sections 2303.23 through 2303.28 will become effective.

The proposed amendment to add authority citations is reasonably necessary to include the citations to the laws that provide the commissioner with the authority to adopt regulations that relate to the reserve financing transactions that sections 2303.23 through 2303.28 relate to. The remainder of the authority citations remain the same as they were the citations provided to establish the commissioner’s authority to adopt or amend regulations relating to licensure, 1011(c) review, and credit for reinsurance as detailed in sections 2303.1 through 2303.22. Providing correct authority citations is necessary to provide clarity as to what authority the commissioner is relying on.

The proposed amendment to add reference citations is reasonably necessary to make clear what specific statutes the commissioner is implementing, interpreting, or making specific with these regulations. The additional citations relate specifically to the statutes regarding the reserve financing transactions that sections 2303.23 through 2303.28 relate to. The remainder of the reference citations remain the same as they were the citations relating to licensure, 1011(c) review, and credit for reinsurance as detailed in sections 2303.1 through 2303.22.

ANTICIPATED BENEFITS FROM THE REGULATORY ACTION (Government Code § 11346.2(b)(1))

The Department anticipates numerous benefits from the proposed changes to sections 2303.23 through 2303.28. First, the Department anticipates that consumers will benefit by the creation of a regulatory regime that ensures that when policyholders make claims on policies subject to the regulations there will be sufficient security to support the reserves ceded in the reinsurance transaction. Moreover, cedents will benefit because the proposed regulations establish clear requirements for the types of security that can be held to back the reserves for cessions made to specific types of reinsurers, and how cedents should claim credit for those cessions. Additionally, the Department anticipates that Model #787 will become an accreditation standard no later than January 1, 2022. There is great value in uniformity for interstate commerce. A standard set of rules will simplify practices when conducting business across state lines and could open new opportunities for future expansion into markets with very little entry cost. Making

California consistent with NAIC requirements that will eventually exist in all other states will simplify regulatory compliance efforts for the affected companies, likely leading to time savings and less operational confusion.

California domestic insurance companies will benefit from the proposed changes to sections 2303.1 through 2303.22 which make filing requirements and internal reference citations clear and easy to follow. Substantive changes that clean up the regulations benefit all applicants, since the proposed changes incorporate the policies the Department memorialized in Bulletin No. 2011-2 and concepts in the Insurance Code as a result of SB 1216. Without the proposed changes, parts of the regulations would not be consistent with Bulletin No. 2011-2, which could potentially cause confusion to cedents and reinsurers alike.

ECONOMIC IMPACT ASSESSMENT (Government Code § 11346.3(b)(2))

Costs Anticipated From the Proposed Amendments

There are no cost impacts or change in business practices anticipated by the proposed addition of sections 2303.23 through 2303.28 of the regulations. Proposed sections 2303.23 through 2303.28 of the regulations are based on NAIC Model #787, which was created to codify the NAIC's Actuarial Guideline XLVIII Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830) (AG 48), and create a clear and consistent process to be used by state regulators when reviewing such transactions. AG 48 became effective January 1, 2015, thus, since 2015 insurance companies entering into XXX and AXXX reserve financing transactions have had to comply with AG 48.

It is anticipated that the proposed regulations will be applied to very few California domestics. For example, there are only two life and health domestic insurers which have reported XXX reinsurance cessions in their statutory financial statements. In these two instances, the XXX cessions were minimal and there was no reinsurance collateral required for either of them because both cessions were ceded to U.S. authorized reinsurers. These particular transactions would not have been affected by the proposed regulations. Due to the small number of domestic life and health insurers in California, and based on their history of ceding to U.S. authorized reinsurers, the Department estimates that no domestic life and health insurer will cede XXX or AXXX business that would be affected by this proposed regulation in the first year after the regulation goes into effect.

The Department's conclusions about cost impacts have been reinforced by analysis performed by the NAIC. Specifically, the NAIC Reinsurance Task Force, in its discussion on whether Model #787 should become an accreditation standard, rejected the proposition that any costs imposed on insurers would be substantial or even quantifiable. The NAIC stated that Model #787 does not require dramatic changes from how insurance companies have been financing XXX/AXXX captive reinsurance transactions since the NAIC's adoption of AG 48 in 2015.

With respect to other proposed changes in the regulations, there are no cost impacts anticipated by the changes in sections 2303 through 2303.22 and in sections 2303.29 and 2303.30 of the regulations. The correction of incorrect citations and the removal of defunct terms, such as "volume insurer," throughout the regulations will not alter business operations or have a cost impact on insurers. There is no economic impact anticipated by changing the phrase "per line of business" to "per reinsurance agreement" in section 2303.15(b) as this is a semantic change and the requirement for domestics to retain at least 10% of direct premium written remains. Whether the 10% is applied to the total reinsurance agreement or individually to each line of business ceded, the total amount needed to be retained would be the same [10% x 200 = (10% x 100) + (10% x 100)]. Additionally, in section 2303.21, a new subdivision (h) was added regarding the filing of certified reinsurer applications, which included a deposit of $1,500 per initial or passport application or annual filing. However, since a deposit of $1,500 was required under the deleted section (h) which related to the notice filings required under section 2303.15(g), and the proposed regulation does not affect the frequency or number of applications submitted by certified reinsurers, there is no anticipated economic impact due to the changes in this subdivision. Finally, with respect to proposed revisions that update the regulations to comply with the reinsurance provisions of Dodd-Frank, the changes simply memorialize a governing bulletin that has been in effect since 2011. *See* Bulletin 2011-2, issued on April 11, 2011, in response to the reinsurance portions of Dodd-Frank. Other changes to sections 2303 through 2303.22 of the regulations clarify filing procedures for certified reinsurer applications and the notice of reinsurance recoverables, both which are required by the Insurance Code as a result of SB 1216. Thus, the revisions in sections 2303 through 2303.22 either simplify the text or align it with current business practices.

Economic Impact Assessment

California Government Code sections 11346.3(b)(1)(A) through (C)

The proposed regulations are projected to have a negligible impact on employment within the State of California. *See* Cal. Gov. Code § 11346.3(b)(1)(A). The proposed regulation is not expected to impact the creation of new businesses or the elimination of existing businesses within California. *See* Cal. Gov. Code § 11346.3(b)(1)(B). Finally, the Department has determined that the proposed regulations will not affect the ability of California businesses to expand. *See* Cal. Gov. Code § 11346.3(b)(1)(C).

The Economic Impact on Jobs, Businesses and the State Economy

The Creation or Elimination of Jobs

There is no estimated impact on jobs based on the proposed regulations. Any impact that may occur would be minimal.

The Creation of New Businesses or the Expansion of Existing Businesses

There is no estimated impact on the creation of new businesses or the expansion of existing business due to the proposed regulations. Any impact that may occur would be minimal.

<u>Health and Welfare Effects, the Impact on Worker Safety and Environmental Effects</u>
The Department has also assessed whether and to what extent the proposed regulations affect other criteria set forth in Government Code sections 11346.3(b)(1)(D).

Worker Safety and Environmental Effects
The changes in the proposed regulations will not impact worker safety. Compliance with the proposed regulations doesn't change the nature of existing job responsibilities of employees in affected industries. Thus, the proposed regulations will neither increase nor reduce worker safety. The Department has also concluded that there would be no effect on the state's environment.

Health and Welfare Effects
The sections 2303.23 through 2303.28 of the proposed regulations will benefit the policyholders of California domestic life insurance companies as they can be assured that the appropriate amount and type of security is being held by or on behalf of a ceding California domestic insurer for covered policies. This means that when policyholders make claims on covered policies there will likely be sufficient security to support the reserves ceded as a result of the reinsurance transaction, which promotes the welfare of consumers.

<u>Adverse Impact on Small Business</u>
The proposed regulations are not anticipated to have any adverse economic impact. Additionally, by law, insurers are not considered small businesses. *See* Cal. Gov. Code § 11342.610(b)(2).

REASONABLE ALTERNATIVES AND PERFORMANCE STANDARD (Government Code § 11346.2(b)(4)(A) and § 11346.2(b)(4)(B)

<u>Adverse Impact on Small Business</u>
The Department contemplated reasonable alternatives that would lessen any adverse impact on small businesses, however, the Department does not anticipate an adverse impact on small business. As discussed in the foregoing analysis, the proposed regulations will have a minimal direct impact on insurers, and by law, they are not considered small businesses. *See* Cal. Gov. Code § 11342.610(b)(2).

<u>Analysis of Alternatives to the Proposed Regulation</u>

Alternative 1: Maintain the Status Quo
CDI considered maintaining the status quo and keeping the current regulations that have inconsistent cross-references, defunct terms and no framework for reserve financing transactions. Maintaining the status quo will not subject insurers to any additional costs, nor will it provide insurers or consumers with any benefits.

<u>Reasons for rejecting Alternative #1</u>
The Department considers the inconsistencies in sections 2303.1 through 2303.22 of the regulations confusing, and the potential reserve financing transactions as exerting

possible anti-consumer impacts. If insurers are confused regarding filing requirements and application of the regulations, then there is a greater potential for inconsistency and the violation of filing requirements. Without clear, uniform standards governing reserve financing transactions, cedents may enter into types of transactions that pose the risk of inadequate reserves and insolvency, to the detriment of consumers when claims are made.

Alternative 2: Adopting only the changes in Sections 2303.1 through 2303.22
The Department considered only adopting the changes in sections 2303.1 through 2303.22 to clean up the existing Reinsurance Oversight Regulations.

Reasons for rejecting Alternative #2
This alternative was rejected because it did not provide all of the benefits of the proposed regulations. This alternative also ignores the changes made in accordance with the recently-adopted NAIC Model #787. Implementing this alternative would likely have a future fiscal impact due to the Department no longer being in compliance with NAIC accreditation standards.

SPECIFIC TECHNOLOGIES OR EQUIPMENT / PRESCRIBED SPECIFIC ACTIONS OR PROCEDURES (Government Code §§ 11346.2(b)(1), 11346.2(b)(4)(A))

Adoption of the proposed amendments and additions to the regulations would not mandate the use of specific technologies or equipment. Additionally, adoption of the proposed amendments and additions to the regulations does not prescribe specific actions or procedures. The Department considered performance standards, but it was determined that performance standards were inappropriate for the proposed amendments to the regulation, which "clean-up" the existing regulatory scheme, and the proposed additions to the regulation, which adopts an NAIC model regulation.

TECHNICAL, THEORETICAL OR EMPIRICAL STUDY, REPORT OR SIMILAR DOCUMENT RELIED UPON (Government Code § 11346.2(b)(3))
The Department identifies the following technical, theoretical or empirical study, report, or similar document relied upon by the Department in the proposed regulation:

1) NAIC Term and Universal Life Insurance Reserve Financing Model Regulation (#787).

2) Cal. Dep't of Ins., Bulletin No. 2011-2, Implementation of Reinsurance Provisions of the Federal Nonadmitted and Reinsurance Reform Act (Apr. 11, 2011).

3) JOSEPH LEE & RANI ISAAC, CAL. DEP'T OF INS., ECONOMIC IMPACT ASSESSMENT: REINSURANCE OVERSIGHT REGULATIONS (2017).

4) N.Y. STATE DEP'T OF FIN. SERV., SHINING A LIGHT ON SHADOW INSURANCE: A LITTLE-KNOWN LOOPHOLE THAT PUTS INSURANCE POLICYHOLDERS AND TAXPAYERS AT GREATER RISK (2013).

5) SCOTT E. HARRINGTON, THE USE OF CAPTIVE REINSURANCE IN LIFE INSURANCE (2014).

6) SCOTT E. HARRINGTON, THE ECONOMICS AND REGULATION OF CAPTIVE REINSURANCE IN LIFE INSURANCE (2014).

7) Memorandum from John Finston, Chair of the NAIC Reinsurance (E) Task Force on 2016 Revisions to Model Law (#785) and Model Regulation (#787) to the Financial Regulations Standards and Accreditation (F) Committee (Mar. 20, 2017).

8) NAIC Model Law Webinar, *Term and Universal Life Insurance Reserve Financing Model Regulation (#787): Regulation of XXX/AXXX Captive Reinsurance Transactions* (Mar. 21, 2017).

PRE-NOTICE DISCUSSIONS (Government Code § 11346.45(a))

The Department conducted pre-notice public discussions pursuant to Government Code section 11346.45(a) on March 16, 2017. Interested and affected parties were given an opportunity to present statements or comments with respect to the proposed amendments. The Department considered these statements and comments in drafting the proposed amendments.