January 12, 1993
BULLETIN #550
BULLETIN TO ALL MEMBERS:
RE: PROPOSED REGULATORY ACTION - MINIMUM RESERVE STANDARDS FOR VALUATION OF DISABILITY INSURANCE CONTRACTS

The Commissioner proposes to adopt Article 3.5 in Title 10 of the California Code Regulations pertaining to the minimum reserved standards for valuation of Disability Insurance Contracts. No public hearing has been scheduled, however any interested person may submit to the Commissioner written comments which must be received by 5:00 p.m. on January 22, 1993.

Inquiries concerning the substance of the proposed regulation should be directed to W. Harold Phillips, Senior Life Actuary, California Department of Insurance, 3450 Wilshire Blvd., Los Angeles, CA 90010, (213) 736-7582.

James S. Pugh
Assistant Manager

JSP/asm
Enclosure

TITLE 10 INSURANCE COMMISSIONER

NOTICE OF PROPOSED RULEMAKING

The Insurance Commissioner ("Commissioner") plans to adopt the proposed regulations described below after considering all comments, objections or recommendations regarding the proposed action.

PROPOSED REGULATORY ACTION

The Commissioner proposes to adopt Article 3.5, including sections 2310 through 2315, in Title 10 of the California Code of Regulations (CCR). These sections pertain to the minimum reserve standards for valuation of disability insurance contracts.

PUBLIC HEARING

No public hearing has been scheduled on the proposed action. However, a hearing will be held if the Commissioner receives a written request for a public hearing from an interested person no later than 15

days prior to the close of the written comment period.

WRITTEN COMMENT PERIOD

Any interested person may submit to the Commissioner written comments relevant to the proposed regulatory action. The written comment period closes at 5 p.m. on January 22, 1993. All comments must be received by that time. Submit comments in writing to:

California Department of Insurance
Attention: Alice Gates
45 Fremont Street, 24th Floor
San Francisco, California 94105

No comments may be delivered by facsimile transmission.
AUTHORITY AND REFERENCE

California Insurance Code section 10489.95 authorizes and mandates that the Commissioner adopt the proposed regulations, which would implement, interpret or make specific sections 10489.15(a) and 997 of the Insurance Code.

INFORMATIVE DIGEST

Currently, Insurance Code 997 addresses the issue of disability insurance reserves, but authorizes only general principles and partial minimum reserve standards in a limited number of categories. 997 also authorizes the commissioner to promulgate regulations setting specific standards for disability insurance reserves. Currently, Insurance Code _0489.1 et seg., establishes a "Standard Valuation Law" in which specific minimum reserve standards are required for life insurance and disability insurance. Insurance Code 10489.2 et seg. , sets forth the minimum standards for life insurance; 10489.95 mandates that the Commissioner adopt a regulation setting minimum standards applicable to the valuation of disability insurance.

The proposed regulation, Article 3.5, adopts specific minimum reserve standards for disability insurance by adopting those standards as developed by the National Association of Insurance Commissioners for use in all states. Section 2310 states the general rule on reserve adequacy. Section 2311 specifies definitions of relevant technical terms. Section 2312 identifies the minimum standards for the three elements of overall reserves: claim reserves, premium reserves and contract reserves. Section 2313 addresses the calculation of reinsurance credits. Section 2314 addresses the calculation for waiver of premium benefits. Section 2315 provides the specific tables to be used for morbidity, interest and mortality.

The Commissioner has determined that there is no existing comparable federal regulation or statute.

DISCLOSURES REGARDING THE PROPOSED ACTION
Mandate on local agencies and school districts: None.
Cost or savings to any state agency: None.

Cost to any local agency or school district which must be reimbursed in accordance with Government Code _7561: None

Other non-discretionary cost or savings imposed upon local agencies: None

Cost or savings in federal funding to the state: None.

Cost impact on private persons or directly affected businesses: Not significant (a one-time transition cost for some insurers).

Significant adverse economic effect on small business: None.
Significant effect on housing costs: None.

CONSIDERATION OF ALTERNATIVES
In accordance with Government Code 11346.5(a)(7), the Commissioner must determine that no alternative considered by the Department would be more effective in carrying out the purpose for which this regulation is proposed or would be as effective and less burdensome to affected private persons than the proposed regulation.

CONTACT PERSONS

Inquiries concerning the substance of the proposed regulation may be directed to:

W. Harold Phillips, Senior Life Actuary
California Department of Insurance
3450 Wilshire Blvd.
Los Angeles, California 90010
(213) 736-7582

Requests for copies of the proposed text, the initial statement of reasons, the modified text, if any, or other information upon which the rulemaking is based, should be directed to:

Alice Gates, Senior Staff Counsel
California Department of Insurance
45 Fremont Street, 24th Floor
San Francisco, California 94105
(415) 904-5721

AVAILABILITY OF STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION

The Commissioner will have the entire rulemaking file available for inspection and copying throughout the rulemaking process at the office at the above San Francisco address. As of the date of publication in the Notice Register, the rulemaking file consists of this notice, the proposed text of the regulations and the initial statement of reasons. Copies may be obtained by contacting Alice Gates at the San Francisco

address listed above.

AVAILABILITY OF CHANGED OR MODIFIED TEXT

If modifications are made to the proposed text, the modified text - with changes clearly indicated - shall be made available to the public for at least 15 days prior to the date on which the Commissioner adopts the regulations. Requests for copies of any modified regulations should be sent to the attention of Alice Gates at the San Francisco address listed above. The Commissioner will accept written comments on the modified regulations for 15 days after the date on which they are made available.

AFFECTED SMALL

This notice shall be sent to all disability insurers (large and small) admitted to transact insurance in California. The commissioner has identified this group as the group of businesses or enterprises which will be affected by this proposed regulation.

File No. RH - 312
Date Published in CRNR: 11-20-92

CALIFORNIA DEPARTMENT OF INSURANCE
LEGAL DIVISION
45 FREMONT STREET
SAN FRANCISCO, CALIFORNIA 94105

FILE NO. RH - 312
DATE PUBLISHED IN CRNR: 11-20-92

INITIAL STATEMENT OF REASONS

Article 3.5 MINIMUM RESERVE STANDARDS FOR VALUATION OF DISABILITY INSURANCE CONTRACTS

INTRODUCTION:

The Legislature has determined that the establishment of adequate reserves is necessary to ensure that life and disability insurers will be able to fulfill the obligations under their contracts. In Insurance Code 10489.1 et seg. the Legislature has established statutory minimum reserve standards for life insurance and in 10489.95, it has mandated that the Insurance Commissioner establish similar standards for disability insurance.

Similarly, the National Association of Insurance Commissioners (NAIC) has developed a Model Regulation titled "Minimum Reserve Standards for Individual and Group Health Insurance Contracts" for the same purpose: to safeguard the public's interest in disability insurance policies. The Model has been developed with significant input from the insurance industry and approved by a majority of state insurance commissioners. The regulation proposed here, Article 3.5, is an adaptation of the NAIC Model Regulation. (Because the California Insurance Code recognizes "disability" and not "health" insurance,

all references in the Model to health insurance have been changed to disability insurance). Adoption by California of the NAIC Model would further the Legislature's goal of consumer protection and it would promote uniformity among the states in the regulation of the insurance industry.

TECHNICAL, THEORETICAL, AND OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS.

The Commissioner did not rely upon any special technical, theoretical, or empirical studies, reports or documents as a basis for proposing the adoption of these regulations, although general principles of actuarial science and various actuarial studies have been used in developing the substance of these regulations.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESSES.

No alternatives were considered which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulations.

2310 GENERAL RULE ON RESERVE ADEQUACY

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

The ability of insurers to fulfill the obligations under their contracts is dependent on the establishment of adequate reserves. Currently, California Insurance Code 997 authorizes only general principles and partial minimum reserve standards in a limited number of categories. Without specific and complete minimum standards, it is more likely that insurers may underprice products and fail to set aside adequate amounts in reserves for future claims, in order to gain market share, thereby placing in peril their claims-paying ability and perhaps their solvency.

SPECIFIC PURPOSE OF THE REGULATION.

2310 introduces specific and complete minimum reserve standards; it informs insurers of the overall tests that will be applied by the Commissioner to determine whether reserves are adequate; it lists the elements that will be taken into account; it advises on action to be taken when inadequacy is found; it provides for situations that are exceptions to the general rule; it names the three categories of reserves and requires adequacy in each category.

The establishment of this standard will enable the Commissioner and the insurers, at earlier stages than is currently possible, to identify inadequacies in reserves. Solvency will be enhanced because reserves will generally be strengthened. It will also establish some uniformity in reserving practices and thereby simplify review.

52311 DEFINITIONS

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

The many different insurers who will use these minimum standards may have different understandings of the technical or unusual terms used in this regulation.

SPECIFIC PURPOSE OF THE REGULATION.

To provide for consistent interpretation of the terms used.

NECESSITY.

These definitions were chosen at the NAIC and reflect general usage by actuaries in the disability or health insurance field. This section explicitly defines the terms for use by non-actuaries in the insurance industry and insurance regulation.

2312 CLAIM RESERVES; PREMIUM RESERVES; CONTRACT RESERVES

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

Since existing standards for reserve adequacy are only very general, there is lack of uniformity in the industry. For example, some insurers may not consider all three categories of reserves in calculating reserve adequacy and may define those categories differently. Review by way of comparison is therefore difficult.

SPECIFIC PURPOSE OF THE REGULATION.

2312 elaborates on the three categories of reserves that have been identified as necessary in determining overall reserve adequacy. 2312 defines each category, sets forth a general rule on establishing the reserves; establishes the principle that reserves calculated according to the morbidity, mortality, interest and termination rates specified are considered minimum reserves; and identifies the exceptions to the rules.

NECESSITY.

In the opinion of the Commissioner and the NAIC, establishment of a minimum standard in all three reserve categories is necessary to ensure consistent and reliable protection of insureds, to allow for review by comparison and to otherwise promote uniformity among insurers.

2313 REINSURANCE

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

Reinsurance reserve credits (the credits the original writer takes against the reserves it sets up) may have

significant effect on the insurer's surplus. Because there is no existing rule requiring that methodology used in determining reinsurance reserve credits must be consistent with the calculation on the direct side, insurers may tend to state high credits and low gross reserves.

SPECIFIC PURPOSE OF THE REGULATION.

2313 requires that reinsurance reserve credits be determined in a manner consistent with the standards set forth in Article 3.5.

NECESSITY.

In the opinion of the Commissioner and the NAIC, the requirement for consistent methodology in determining reserves and reinsurance reserve credits is necessary to ensure proper financial reporting and is a necessary element in the overall strategy to ensure reserve adequacy, to monitor and strengthen solvency, to allow for review by comparison and to otherwise promote uniformity among insurers.

2314 RESERVES FOR WAIVER OF PREMIUM

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

"Waiver of Premium" is a benefit offered in many disability products. It has the effect of paying the premium and continuing the coverage in-force when the insured is disabled. Contracts in force include active lives and disabled lives. Reserves for the premium waiver benefit can be provided in two ways: one, using an "active life" table and the other, using an "in force" table. Currently, there is no rule or guideline that outlines the principles of each approach. As a result, insurers may calculate reserves incorrectly, usually too low.

SPECIFIC PURPOSE OF THE REGULATION.

2314 authorizes the use of the "in-force" tables, as compared with "active life" tables, only if certain additional reserves related to the waiver of premium benefit are established.

NECESSITY.

These additional requirements are necessary to protect against under-reserving and to assure consistency in reserving.

2315 SPECIFIC STANDARDS FOR MORBIDITY, INTEREST AND MORTALITY

PUBLIC PROBLEM, ADMINISTRATIVE REQUIREMENT, OR OTHER CONDITION OR CIRCUMSTANCE THAT THE REGULATION IS INTENDED TO ADDRESS.

Although 2310 in this regulation states the general principle that reserve adequacy must be maintained and identifies the overall tests that will be applied to determine adequacy, there is no specific guide for

the insurer as to which particular actuarial tables to use to achieve the objectives stated in 2310.

SPECIFIC PURPOSE OF THE REGULATION.

2315 presents the specific actuarial tables to be used to calculate and determine reserve adequacy. These are arranged based on morbidity, interest and mortality; individual and group insurance; types of benefits and category of reserves.

NECESSITY.

This section specifies the tools that actuaries may use to achieve compliance with this regulation. It therefore facilitates compliance and clarifies the precise standard that must be met.

CALIFORNIA DEPARTMENT OF INSURANCE
LEGAL DIVISION
45 FREMONT STREET
SAN FRANCISCO, CALIFORNIA 94105

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CALIFORNIA CODE OF REGULATIONS, TITLE 10, CHAPTER 5, SUBCHAPTER 3,

PROPOSAL TO ADOPT ARTICLE 3.5, SECTIONS 2310 THROUGH 2315, TO READ:

MINIMUM RESERVE STANDARDS FOR VALUATION OF DISABILITY INSURANCE CONTRACTS

2310 General Rule

(a) Applicability

These standards apply to all individual and group disability insurance except credit insurance.

(b) Reserve Adequacy

With respect to any block of contracts, or with respect to an insurer's disability business as a whole, a prospective gross premium valuation is the ultimate test of reserve adequacy as of a given valuation date. Such a gross premiums valuation will take into account, for contracts in force, in a claims status, or in a continuation of benefits status on the valuation date, the present value as of the valuation date of: all expected benefits unpaid, all expected expenses unpaid, and all unearned or expected premiums, adjusted for future premium increases reasonably expected to be put into effect.

Such a gross premium valuation shall be performed whenever a significant doubt exists as to reserve adequacy with respect to any major block of contracts, or with respect to the insurer's disability business as a whole. In the event inadequacy is found to exist, immediate recognition shall be made and the

reserves restored to adequacy. Adequate reserves (inclusive of claim, premium and contract reserves, if any) shall be held with respect to all contracts, regardless of whether contract reserves are required for such contracts under these standards.

Whenever minimum reserves, as defined in this article, exceed reserve requirements as determined by a prospective gross premium valuation, such minimum reserves remain the minimum requirement under this articles.

When an insurer determines that adequacy of its disability insurance reserves requires reserves in excess of the minimum standards specified herein, such increased reserves shall be held and shall be considered the minimum reserves for that insurer.

Adequacy of an insurer's disability insurance reserves shall be determined on the basis of the following three categories combined: claim reserves, premium reserves and contract reserves. However, adequate reserves for each of the three categories shall be separately achieved.

NOTE: Authority Cited: 997(a) and 10489-95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2311 Definitions

For purposes of this article, the following definitions apply:

(a) "Annual Claim Cost" is the net annual cost per unit of benefit before the addition of expenses, including claim settlement expenses, and a margin for profit or contingencies. For example, the annual claim cost for a $100 monthly disability benefit, for a maximum disability benefit period of one year, with an elimination period of one week, with respect to a male at age 35, in a certain occupation might be $12, while the gross premium for this benefit might be $18. The additional $6 would cover expenses and profit or contingencies.

(b) "Claims Accrued" means that portion of claims incurred on or prior to the valuation date which result in liability of the insurer for the payment of benefits for medical services which have been rendered on or prior to the valuation date, and for the payment of benefits for days of hospitalization and days of disability which have occurred on or prior to the valuation date, which the insurer has not paid as of the valuation date, but for which it is liable, and will have to pay after the valuation date. This liability is sometimes referred to as a liability for "accrued" benefits. A claim reserve, which represents an estimate of this accrued claim liability, must be established.

(c) "Claim Reported": When an insurer has been informed that a claim has been incurred, if the date reported is on or prior to the valuation date, the claim is considered as a reported claim for annual statement purposes.

(d) "Claims Unaccrued" are the portion of claims incurred on or prior to the valuation date which result in liability of the insurer for the payment of benefits for identical services expected to be rendered after the valuation date, and for benefits expected to be payable for days of hospitalization and days of

disability occurring after the valuation date. This liability is sometimes referred to as a liability for unaccrued benefits. A claim reserve, which represents an estimate of the unaccrued claim payments expected to be made (which may or may not be discounted with interest), must be established.

(e) "Claims Unreported": When an insurer has not been informed, on or before the valuation date, concerning a claim that has been incurred on or prior to the valuation date, the claim is considered as an unreported claim for annual statement purposes.

(f) "Date of Disablement" is the earliest date the insured is considered as being disabled under the definition of disability in the contract, based on a doctor's evaluation or other evidence. Normally this date will coincide with the start of any elimination period.

(g) "Elimination Period" is a specified number of days, weeks, or months starting at the beginning of each period of loss, during which no benefits are payable.

(h) "Gross Premium" is the amount of premium charged by the insurer. It includes the net premium (based on claim-cost) for the risk, together with any loading for expenses profit or contingencies.

(i) "Group Insurance" includes blanket insurance and franchise insurance and any other forms of group insurance.

(j) "Level Premium" is a premium calculated to remain unchanged throughout either the lifetime of the policy, or for some shorter projected period of years. The premium need not be guaranteed; in which case, although it is calculated to remain level, it may be changed if any of the assumptions on which it was based are revised at a later time.

Generally, the annual claim costs are expected to increase each year and the insurer, instead of charging premiums that correspondingly increase each year, charges a premium calculated to remain level for a period of years or for the lifetime of the contract. In this case the benefit portion of the premium is more than needed to provide for the cost of benefits during the earlier years of the policy and less than the actual cost in the later years. The building of a prospective contract reserve is a natural result of level premiums.

(k) "Long-Term Care Insurance" is as defined in Insurance Code Section 10231.2.

(1) "Modal Premium" is the premium paid on a contract- based on a premium term which could be annual, semi-annual, quarterly, monthly, or weekly. Thus if the annual premium is $100 and if, instead, monthly premiums of $9 are paid then the modal premium is $9.

(m) "Negative Reserve": Normally the terminal reserve is a positive value. However, if the values of the benefits are decreasing with advancing age or duration it could be a negative value, called a negative reserve.

(n) "Preliminary Term Reserve Method" is a method of reserve valuation under which the valuation net premium for each year falling within the preliminary term period is exactly sufficient to cover the

expected incurred claims of that year, so that the terminal reserves will be zero at the end of the year. As of the end of the preliminary term period, a new constant valuation net premium (or stream of changing valuation premiums) becomes applicable such that the present value of all such premiums is equal to the present value of all claims expected to be incurred following the end of the preliminary term period.

(o) "Present Value of Amounts Not Yet Due on Claims" is the reserve for "claims unaccrued" (as defined in subsection (d)), which may be discounted at interest.

(p) "Reserve" includes all items of benefit liability, whether in the nature of incurred claim liabilitys in the nature of contract liability relating to future periods of coverage, and whether the liability is accrued or unaccrued.

An insurer under its contracts promises benefits which result in:

(1) Claims which have been incurred, that is, for which the insurer has become obligated to make payment, on or prior to the valuation date. On these claims, payments expected to be made after the valuation date for accrued and unaccrued benefits are liabilities of the insurer which shall be provided for by establishing claim reserves; or

(2) Claims which are expected to be incurred after the valuation date. Any present liability of the insurer for these future claims shall be provided for by the establishment of contract reserves and unearned premium reserves.

(q) "Terminal Reserve" is the reserve at the end of a contract year, and is defined as the present value of benefits expected to be incurred after that contract year minus the present value of future valuation net premiums.

(r) "Unearned Premium Reserve" values that portion of the premium paid or due to the insurer which is applicable to the period of coverage extending beyond the valuation date. Thus if an annual premium of $120 was paid on November 1, $20 would be earned as of December 31 and the remaining $100 would be unearned. The unearned premium reserve could be on a gross basis as in this example, or on a valuation net premium basis.

(s) "Valuation Net Modal Premium" is the modal fraction of the valuation net annual premium that corresponds to the gross modal premium in effect on any contract to which contract reserves apply. Thus if the mode of payment in effect is quarterly, the valuation net modal premium is the quarterly equivalent of the valuation net annual premium.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2312 Claim Reserves

(a) General Rule

(1) Claim reserves are required for all incurred but unpaid claims (these include all claims accrued and unaccrued, reported and unreported) on all disability insurance policies.

(2) Appropriate claim expense reserves are required with respect to the estimated expense of settlement of all incurred but unpaid claims.

(3) All such reserves for prior valuation years are to be tested for adequacy and reasonableness along the lines of claim runoff schedules in accordance with the statutory financial statement including consideration of any residual unpaid liability.

(b) Minimum Standards for Claim Reserves

(1) Disability Income

(A) Interest. The maximum interest rate for claim reserves is specified in 2315.

(B) Morbidity. Minimum standards with respect to morbidity are those specified in 2315; except that, at the option of the insurer, for claims with a duration from date of disablement of less than two years, reserves may be based on the insurer's experience, if such experience is credible, or upon other assumptions designed to place a sound value on the liabilities.

(C) Duration of Disablement. For contracts with an elimination period, the duration of disablement shall be measured as dating from the time that benefits would have begun to accrue had there been no elimination period.

(2) All Other Benefits

(A) Interest. The maximum interest rate for claim reserves is specified in 2315.

(B) Morbidity or other Contingency. The reserve shall be based on the insurer's experience, if such experience is considered credible, or upon other assumptions designed to place a sound value on the liabilities.

(c) Claim Reserve Methods Generally

Any generally accepted or reasonable actuarial method or combination of methods may be used to estimate all claim liabilities. The methods used for estimating liabilities generally may be aggregate methods, or various reserve items may be separately valued. Approximations based on groupings and averages may also be employed. Adequacy of the claim reserves, however, shall be determined in the aggregate.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2312.3 Premium Reserves

(a) General Rule

(1) Unearned premium reserves are required for all contracts with respect to the period of coverage for which premiums, other than premiums paid in advance, have been paid beyond the date of valuation.

(2) If premiums due and unpaid are carried as an asset, such premiums shall be treated as premiums in force, subject to unearned premium reserve determination. The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums shall be carried as an offsetting liability.

(3) The gross premiums paid in advance for a period of coverage commencing after the next premium due date which follows the date of valuation may be discounted, at rates not exceeding those in 2315(b), to the valuation date and shall be held either as a separate liability or as an addition to the unearned premium reserve which would otherwise be required as a minimum.

(b) Minimum Standards for Unearned Premium Reserves

(1) The minimum unearned premium reserve with respect to any contract shall be the pro rata unearned modal premium that applies to the premium period beyond the valuation date, with such premium determined on the basis of:

(A) The valuation net modal premium on the contract reserve basis applying to the contract; or

(B) The gross modal premium for the contract if no contract reserve applies.

(2) In no event shall the sum of the unearned premium and contract reserves for all contracts of the insurer subject to contract reserve requirements be less than the gross modal unearned premium reserve on all such contracts, as of the date of valuation. Such reserve shall never be less than the expected claims for the period beyond the valuation date represented by such unearned premium reserve, to the extent not provided for elsewhere.

(c) Premium Reserve Methods Generally

The insurer may employ suitable approximations and estimates; including, but not limited to groupings, averages and aggregate estimation; in computing premium reserves. Such approximations or estimates shall be tested periodically to determine their continuing adequacy and reliability.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2312.5 Contract Reserves

(a) General Rule

(1) Contract reserves are required, unless otherwise specified in paragraph (a)(2) for:

(A) All individual and group contracts with which level premiums are used; or

(B) All individual and group contracts with respect to which, due to the gross premium pricing structure at issue, the value of the future benefits at any time exceeds the value of any appropriate future valuation net premiums at that time. The values specified in this paragraph shall be calculated based on subsection (b).

(2) Contracts not requiring a contract reserve are:

(A) Contracts which cannot be continued after one year from issue; or

(B) Contracts already in force on the effective date of this article for which no contract reserve is required under paragraph (a)(1).

(3) The contract reserve shall be in addition to claim reserves and premium reserves.

(4) The methods and procedures for contract reserves shall be consistent with those for claim reserves for any contract, or else appropriate adjustment shall be made when necessary to assure provision for the aggregate liability. The definition of the date of incurral must be the same in both determinations.

(b) Minimum Standards for Contract Reserves

(1) Morbidity or other Contingency. Minimum standards with respect to morbidity are those set forth in 2315. Valuation net premiums used under each contract shall have a structure consistent with the gross premium structure at issue of the contract as this relates to advancing age of insured, contract duration and period for which gross premiums have been calculated.

Contracts for which tabular morbidity standards are not specified in 2315 shall be valued using tables established for reserve purposes by a qualified actuary and acceptable to the commissioner.

(2) Interest. The maximum interest rate is specified in _315.

(3) Termination Rates. Termination rates used to compute reserves shall be on the basis of a mortality table as specified in 2315 except as noted in the following paragraph:

Under contracts for which premiums rates are not guaranteed, and where the effects of insurer underwriting are specifically used by policy duration in the valuation morbidity standard or for return of premium on other deferred cash benefits, total termination rates may be used at ages and duration's where these exceed specified mortality table rates, but not in excess of the lesser of:

(A) Eighty percent of the total termination rate used in the calculation of the gross premiums, or

(B) Eight percent.

Where a morbidity standard specified in 2315 is on an aggregate basis, such morbidity standard may be

adjusted to reflect the effect of insurer underwriting by policy duration. The adjustments shall be appropriate to the underwriting and shall be acceptable to the Commissioner.

(4) Reserve Method.

(A) For all disability insurance except long-term care and return of premium or other deferred cash benefits, the minimum reserve shall be the reserve calculated on the two-year full preliminary term method; that is, under which the terminal reserve is zero at the first and also the second contract anniversary.

(B) For long-term care insurance, the minimum reserve shall be the reserve calculated on the one-year full preliminary term method.

(C) For return of premium or other deferred cash benefits, the minimum reserve shall be the reserve calculated as follows:

(I) On the one year preliminary term method if such benefits are provided at any time before the twentieth anniversary;

(II) On the two year preliminary term method if such benefits are only provided on or after the twentieth anniversary.

(D) The preliminary term method may be applied only in relation to the date of issue of a contract. Reserve adjustments introduced later, as a result of rate increases, revisions in assumptions (e.g., projected inflation rates) or for 'other reasons, shall be applied immediately as of the effective date of adoption of the adjusted basis.

(5) Negative Reserves. Negative reserves on any benefit may be offset against positive reserves for other benefits in the same contract, but the total contract reserve with respect to all benefits combined shall not be less than zero.

(c) Alternative Valuation Methods and Assumptions Generally

Provided the contract reserve on all contracts to which an alternative method or basis is applied is not less in the aggregate than the amount determined according to the applicable standards specified above, an insurer may use any reasonable assumptions as to interest rates, termination and/or mortality rates, and rates of morbidity or other contingency. Also subject to the preceding condition, an insurer may employ methods other than the methods stated above in determining a sound value of its liabilities under such contracts, including, but not limited to the following: the net level premium method; the one-year full preliminary term method; prospective valuation on the basis of actual gross premiums with reasonable allowance for future expenses; the use of approximations such as those involving age groupings, groupings of several years of issue, average amounts of indemnity, grouping of similar contract forms; the computation of the reserve for one contract benefit as a percentage of, or by other relation to, the aggregate contract reserves exclusive of the benefit or benefits so valued; and the use of a composite annual claim cost for all or any combination of the benefits included in the contracts valued.

(d) Tests For Adequacy and Reasonableness of Contract Reserves

Annually, an appropriate review shall be made of the insurer's prospective contract liabilities on contracts valued by tabular reserves, to determine the continuing adequacy and reasonableness of the tabular reserves, giving consideration to future gross premiums. The insurer shall make appropriate increases to such tabular reserves if such tests indicate that the basis of such reserves is no longer adequate subject to the minimum standards in subsection (b).

If an insurer has a contract or a group of related similar contracts, for which future gross premiums will be restricted by contract, insurance department regulations, or for other reasons, such that the future gross premiums reduced by expenses for administration, commissions and taxes will be insufficient to cover future claims, the insurer shall establish contract reserves for such shortfall in the aggregate.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2313 Reinsurance

Increases to, or credits against, reserves carried, arising because of reinsurance assumed or reinsurance ceded, shall be determined in a manner consistent with these minimum reserve standards and with all applicable provisions of the reinsurance contracts which affect the insurer's liabilities.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2314 Reserves for Waiver of Premium

(a) Because the disability valuation tables promulgated by the NAIC are based on exposures that include contracts on premium waiver as in-force contracts, contract reserves based on these tables are NOT reserves on "active lives" but rather reserves on contracts "in force." This is true for the 1964 CDT and for both the 1985 CIDA and CIDB tables.

Accordingly, tabular reserves using any of these tables shall value reserves on the following basis:

(1) Claim reserves shall include reserves for premiums expected to be waived, valuing as a minimum the valuation net premium being waived.

(2) Premium reserves shall include contracts on premium waiver as in-force contracts, valuing as a minimum the unearned modal valuation net premium being waived.

(3) Contract reserves shall include recognition of the waiver of premium benefit in addition to other contract benefits, valuing as a minimum the valuation net premium to be waived.

(b) If an insurer is, instead, valuing reserves on what is truly an active life table, or if a specific valuation

table is not being used but the insurer's gross premiums are calculated on a basis that includes in the projected exposure only those contracts for which premiums are being paid, then it may not be necessary to provide specifically for waiver of premium reserves. Any insurer using such a true "active life" basis shall determine whether additional liability shall be recognized because of premiums waived during periods of disability or during claim continuation.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.

2315 Specific Standards for Morbidity, Interest and Mortality

These standards apply to claim reserves according to year of incurral and to contract reserves according to year of issue.

(a) Morbidity

(1) Minimum morbidity standards for valuation of specified individual contract benefits:

(A) Disability Income Benefits Due to Accident or Sickness.
(I) Contract Reserves

For contracts issued on or after January 1, 1965 and prior to January 1, 1990: The 1964 Commissioners Disability Table (64 CDT)

For contracts issued during 1990, 1991, or 1992: Optional use of either the 1964 Table or the 1985 Tables.

For contracts issued on or after January 1, 1993: The 1985 Commissioners Individual Disability Tables A (85 CIDA) ; or The 1985 Commissioners Individual Disability Tables B (85 CIDB).

Each insurer shall elect, with respect to all individual contracts issued in any one statement year, either Tables A or Tables B as the minimum standard. The insurer may elect to use the other tables with respect to any subsequent statement year.

(II) Claim Reserves

The minimum morbidity standard in effect for contract reserves on currently issued contracts, as of the date the claim is incurred.

(B) Hospital Benefits, Surgical Benefits and Maternity Benefits (Scheduled benefits or fixed time period benefits only).

(I) Contract Reserves

For contracts issued on or after January 1, 1955, and before January 1, 1982: The 1956 Intercompany Hospital Surgical Tables.

For contracts issued on or after January 1, 1982: The 1974 Medical Expense Tables, Table A, Transactions of the Society of Actuaries, Volume XXX, pg. 63. Refer to the paper (in the same volume, pg. 9) to which this table is appended, including its discussions, for methods of adjustment for benefits not directly valued in Table A: "Development of the 1974 Medical Expense Benefits," Houghton and Wolf.

(II) Claim Reserves: No specific standard. See paragraph (E).

(C) Cancer Expense Benefits (Scheduled benefits or fixed time period benefits only).

(I) Contract Reserves
For contracts issued on or after January 1,1986: The 1985 NAIC Cancer Claim Cost Tables.

(II) Claim Reserves: No specific standard. See paragraph (E).

(D) Accidental Death Benefits

(I) Contracts Reserves
For contracts issued on or after January 1, 1965: The 1959 Accidental Death Benefits Table.
(II) Claim Reserves: Actual amount incurred.
(E) Other Individual Contract Benefits

(I) Contract Reserves

For all other individual contract benefits, morbidity assumptions are to be determined as provided in this article.

(II) Claim Reserves

For all benefits other than disability income, claim reserves are to be determined as provided in this article.

(2) Minimum morbidity standards for valuation of specified group contract benefits:

(A) Disability Income Benefits Due to Accident or Sickness.

(I) Contract Reserves

For contracts issued prior to January 1, 1993: The same basis, if any, as that employed by the insurer as of January 1, 1993

For contracts issued on or after January 1, 1993: The 1987 Commissioners Group Disability Income Table (87CGDT).

(II) Claim Reserves

For contracts issued on or after January 1, 1993: The 1987 Commissioners Group Disability Income Table (87CGDT). (II) Claim Reserves

For claims incurred on or after January 1, 1993: The 1987 Commissioners Group Disability Income Table (87CGDT)

For claims incurred prior to January 1, 1993: Use of the 87CGDT is optional.

(B) Other Group Contract Benefits

(I) Contract Reserves

For all other group contract benefits, morbidity assumptions shall be determined as provided in this article.

(II) Claim Reserves

For all benefits other than disability income, claim reserves shall be determined as provided in this article.

(b) Interest

(1) For contract reserves the maximum interest rate shall be the maximum rate permitted by law in the valuation of whole life insurance issued on the same date as the disability insurance contract.

(2) For claim reserves on policies that require contract reserves, the maximum interest rate shall be the maximum rate permitted by law in the valuation of whole life insurance issued on the same date as the claim incurral date.

(3) For claim reserves on policies not requiring contract reserves, the maximum interest rate shall be the maximum rate permitted by law in the valuation of single premium immediate annuities issued on the same date as the claim incurral date, reduced by one hundred basis points.

(c) Mortality

(1) Except as provided in paragraph (2), the mortality basis used shall be according to a table (but without use of selection factors) permitted by law for the valuation of whole life insurance issued on the same date as the disability insurance contract.

(2) Other mortality rates may be used in the calculation of the minimum reserves, if appropriate for the type of benefits and if approved by the commissioner. The request for such approval must include the proposed mortality basis and the reason that the standard specified in paragraph (1) is inappropriate.

NOTE: Authority Cited: 997(a) and 10489.95, Insurance Code.
Reference: 985, 997 and 10489.15(a), Insurance Code.