HAWAII ADMINISTRATIVE RULES

TITLE 16

DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS

CHAPTER 20

LIFE AND HEALTH REINSURANCE AGREEMENTS

§16-20-1 Purpose. The commissioner recognizes that life and health insurers routinely enter into reinsurance agreements that yield legitimate relief to the ceding insurer from strain to surplus. The commissioner has, however, become aware that some reinsurance agreements have been created for the principal purpose of producing significant surplus aid for the ceding insurer and that these agreements do not transfer all of the significant risks associated with the business being reinsured and provide little or no indemnification of policy benefits by the reinsurer. Taking reserve credit under these types of agreements would create a situation that may be hazardous to policyholders, creditors, or the public or would violate:

(1) Section 431:4-121, HRS, regarding false documents relating to the affairs of an insurer;
(2) Section 431:3-301, HRS, requiring insurers to file a true statement of their financial condition; and
(3) Sections 431:4A-101 and 431:4A-102, HRS, relating to reinsurance reserve credits and permitting ceding insurers to reduce liabilities or establish assets for reinsurance ceded, provided that they do so in a proper manner. [Eff 3/19/94] (Auth: HRS §§431:2-201, 431:4A-104) (Imp: HRS §431:4A-101)

§16-20-2 Scope. This chapter shall apply to all domestic life and health insurers and to all other licensed life insurers which are not subject to a substantially similar regulation in their domiciliary state. This chapter shall also apply to licensed property and casualty insurers with respect to their accident and health business. This chapter shall not apply to assumption reinsurance, yearly renewable term reinsurance, or nonproportional reinsurance such as stop loss or catastrophe reinsurance. [Eff 3/19/94] (Auth: HRS §§431:2-201, 431:4A-104) (Imp: HRS §431:4A-101)

§16-20-3 Accounting requirements. (a) No insurer subject to this chapter shall, on account of reinsurance ceded, reduce any liability or establish any asset in any financial statement filed with the commissioner if the terms of the reinsurance agreement, in substance or effect, provide for any of the following conditions:

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

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

(3) The ceding insurer is required to reimburse the reinsurer for negative experience under the reinsurance agreement; provided, however, that offsetting experience refunds against current and prior year losses under the agreement and payment by the ceding insurer of an amount equal to the current and prior year losses under the agreement when the ceding insurer voluntarily terminates in force reinsurance shall not be considered a reimbursement to the reinsurer for negative experience. Voluntary termination does not include situations where termination occurs because of unreasonable provisions which allow the reinsurer to reduce its risk

under the agreement, such as a provision giving the reinsurer the right to increase reinsurance premiums or risk and expense charges to excessive levels, forcing the ceding company to terminate prematurely the reinsurance treaty;

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

(5) The reinsurance agreement involves the possible payment of reinsurance premiums or other fees or charges by the ceding insurer to the reinsurer of amounts greater than from income realized from the reinsured policies;

(6) The agreement does not transfer all of the significant risk inherent in the business being reinsured. The table entitled Exhibit A at the end of this chapter and made a part of this chapter identifies the risks to be considered significant for a representative sampling of products or types of business. For products not specifically included, the risks determined to be significant shall be consistent with Exhibit A;

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

Notwithstanding the requirements of this subsection, the assets supporting the reserves for the following classes of business and any other classes of business which do not have a significant credit quality reinvestment or disintermediation risk may be held by the ceding company without segregation:

(i) Health insurance, including long term care and long term disability;

(ii) Traditional non-participating permanent;

(iii) Traditional participating permanent;

(iv) Adjustable premium permanent;

(v) Indeterminate premium permanent; or

(vi) Universal life fixed premium with no dump-in premiums allowed.

The associated formula for determining the reserve interest rate adjustment must reflect the ceding company's investment earnings and incorporate all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

$$\text{Rate} = \frac{2(I+CG)}{X+Y-I-CG}$$

Where:

I is the net investment income;

CG is capital gains less capital losses;

X is the current year cash and invested assets plus investment income due and accrued less borrowed money; and

Y is the prior year cash and invested assets plus investment income due and accrues less borrowed money;

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

(9) The ceding insurer is required to make representations or warranties not reasonably related to the business being reinsured;

(10) The ceding insurer is required to make representations or warranties about future performance of the business being reinsured; or

(11) The reinsurance agreement is entered into for the principal purpose of producing significant surplus aid for the ceding insurer and does not transfer all of the significant risks inherent in the business reinsured, and, in substance or effect, the expected potential liability to the ceding insurer remains basically unchanged.

(b) Notwithstanding subsection (a), an insurer subject to this chapter may, with the prior approval of the commissioner, take any reserve credit or establish any asset as the commissioner may deem consistent with Hawaii law and with any actuarial interpretations or standards adopted by the commissioner.

(c) A ceding insurer shall file with the commissioner any agreements entered into after the effective date of this chapter which involve reinsurance of business issued before the effective date of the agreement, along with any subsequent amendments, within thirty days from the date of execution. Each filing shall include a detailed description of the financial impact of the transaction. The actuary who signs the ceding insurer's actuarial opinion with respect to valuation of reserves shall consider this chapter and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with the commissioner. The actuary shall maintain adequate documentation and shall, upon request by the commissioner, describe the actuarial work performed for inclusion in the financial statements and shall demonstrate that the work conforms to the requirements of this chapter.

Any increase in surplus net of federal income tax resulting from arrangements described in this subsection shall be identified separately on the insurer's statutory financial statement as a surplus item (aggregate write-ins for gains and losses in surplus in the capital and surplus account, page four of the annual statement) and recognition of the surplus increase as income shall be reflected on a net of tax basis in the "reinsurance ceded" line of the annual statement as earnings emerge from the business reinsured.

For example, on the last day of calendar year N, company XYZ pays a $20,000,000 initial commission and expense allowance to company ABC for reinsuring an existing block of business. Assuming a thirty-four per cent tax rate, the net increase in surplus at inception is $13,200,000 ($20,000,000 - $6,800,000) which is reported as income on the "commissions and expense allowance on reinsurance ceded" line of the summary of operations.

At the end of year N+1 the business has earned $4,000,000. ABC has paid $500,000 in profit and risk charges in arrears for the year and has received a $1,000,000 experience refund. ABC's annual statement would report $1,650,000 (sixty-six per cent of ($4,000,000 - $1,000,000 - $500,000) up to a maximum of $13,200,000) on the "commissions and expense allowance on reinsurance ceded" line of the summary of operations, and $1,650,000 on the "aggregate write-ins for gains and losses in surplus" line of the capital and surplus account. The experience refund would be reported separately as a miscellaneous income item in the summary of operations. [Eff 3/19/94] (Auth: HRS §§431:2-201, 431:4A-104) (Imp: HRS §431:4A-101)

§16-20-4 Written agreements. (a) No reinsurance agreement, amendment, or binding letter of intent to any agreement may be used to reduce any liability or to establish any asset in any financial statement filed with the commissioner unless the agreement, amendment, or binding letter of intent has been duly executed by both parties no later than the date of the financial statement.

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

(c) The reinsurance agreement shall provide that:

(1) The agreement constitutes the entire agreement between the parties with respect to the business being reinsured and that there are no understandings between the parties other than as expressed in the agreement; and

(2) Any change or modification to the agreement shall be null and void unless made by amendment to the agreement and signed by both parties. [Eff 3/19/94] (Auth: HRS §§431:2-201, 431:4A-104) (Imp: HRS §431:4A-101)

§16-20-5 Existing agreements. Insurers subject to this chapter shall have until December 31, 1994, to reduce to zero any reserve credits or assets established for reinsurance agreements entered into before the effective date of this chapter which, under the provisions of this chapter, would not be entitled to recognition of the reserve credits or assets, so long as the reinsurance agreements comply with laws in existence immediately preceding the effective date of this chapter. [Eff 3/19/94] (Auth: HRS §§431:2-201, 431:4A-104) (Imp: HRS §431:4A-101)

EXHIBIT A

Risk categories:

(A) Morbidity;

(B) Mortality;

(C) Lapse.

The risk that a policy will voluntarily terminate before the statutory surplus strain experienced at issue of the policy is recouped;

(D) Credit Quality.

The risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that assets will default or that there will be a decrease in earning power. Credit quality risk excludes market value declines due to changes in interest rates.

(E) Reinvestment.

The risk that interest rates will fall and funds reinvested (coupon payments or monies received upon asset maturity or call) will earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

(F) Disintermediation.

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

SIGNIFICANCE OF RISK:

	Risk Categories					
	A	B	C	D	E	F
Health insurance, other than long-term care or long term disability	+	o	+	o	o	o
Health insurance, including long-term care or long-term disability	+	o	+	+	+	o
Immediate annuities	o	+	o	+	+	o
Single premium deferred annuities	o	o	+	+	+	+
Flexible premium deferred annuities	o	o	o	+	+	+
Guaranteed interest contracts	o	o	o	+	+	+
Other annuity deposit business	o	o	+	+	+	+
Single premium whole life	o	+	+	+	+	+
Traditional non-participating permanent	o	+	+	+	+	+
Traditional non-participating term	o	+	+	o	o	o
Traditional participating permanent	o	+	+	+	+	+
Traditional participating term	o	+	+	o	o	o
Adjustable premium permanent	o	+	+	+	+	+
Indeterminate premium permanent	o	+	+	+	+	+
Universal life flexible premium	o	+	+	+	+	+
Universal life fixed premium with dump-in premiums allowed	o	+	+	+	+	+

+ - significant   o - insignificant

DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS

Adoption of Chapter 16-20
Hawaii Administrative Rules

December 20, 1993

SUMMARY

Chapter 16-20, Hawaii Administrative Rules, entitled "Life and Health Reinsurance Agreements" is adopted.

DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS

The adoption of Chapter 16-20, Hawaii Administrative Rules, on the Summary page dated December 20, 1993, was adopted on December 20, 1993, following a public hearing held on December 20, 1993, after notices were given in the Honolulu Star-Bulletin, Honolulu Advertiser, Hawaii Tribune-Herald, West Hawaii Today, Maui News and Garden Isle on November 16, 1993.

These rules shall take effect ten days after filing with the Office of the Lieutenant Governor.

/s/ Linda Chu Takayama
LINDA CHU TAKAYAMA
Insurance Commissioner

APPROVED AS TO FORM: Date 2/28/94

/s/ Rodney J. Tam
Deputy Attorney General

APPROVED: Date 3/3/94

/s/ Clifford K. Higa
CLIFFORD K. HIGA, Director
Commerce and Consumer Affairs

APPROVED: Date 3/8/94

/s/ John Waihee
JOHN D. WAIHEE
GOVERNOR OF HAWAII

March 9, 1994
Filed