THE INSURANCE CODE OF 1956 (EXCERPT)
Act 218 of 1956

500.1123 Reinsurance agreement; conditions prohibiting reduction in liability or establishment of asset; approval of commissioner; filing agreements.

Sec. 1123.

(1) For reinsurance ceded an insurer subject to this section shall not reduce any liability or establish any asset in any financial agreement filed with the commissioner if, by the terms of the reinsurance agreement, in substance or effect, any of the following conditions exist:

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

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

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

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

(e) The reinsurance agreement involves the possible payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies. For example, a ceding insurer may not pay reinsurance premiums or other fees or charges to a reinsurer that are greater than the direct premiums collected by the ceding insurer.

(f) The treaty does not transfer all of the significant risk inherent in the business being reinsured. The following table identifies for a representative sampling of products or type of business the risks that are considered to be significant. For products not specifically included, the risks determined to be significant shall be consistent with this table.

Risk Categories:

(i) Morbidity.

(ii) Mortality.

(iii) Lapse. This is the risk that a policy will voluntarily terminate prior to the recoupment of a statutory surplus strain experienced at issue of the policy.

(iv) Credit quality (C1). This is the risk that invested assets supporting the reinsured business will decrease in value. The main hazards are that the assets will default or that there will be a decrease in earning power. It excludes market value declines due to changes in interest rate.

(v) Reinvestment (C2). This is the risk that interest rates will fall and funds reinvested, such as coupon payments or money received upon asset maturity or call, will therefore earn less than expected. If asset durations are less than liability durations, the mismatch will increase.

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

Risk Category

	(i)	(ii)	(iii)	(iv)	(v)	(vi)
Health insurance - other than LTC/LTD*	+	0	+	0	0	0
Health insurance - LTC/LTD*	+	0	+	+	+	0

Immediate annuities	0	+ 0 + + 0
Single premium deferred annuities	0	0 + + + +
Flexible premium deferred annuities	0	0 + + + +
Guaranteed interest contracts	0	0 0 + + +
Other annuity deposit business	0	0 + + + +
Single premium whole life	0	+ + + + +
Traditional nonpar permanent	0	+ + + + +
Traditional nonpar term	0	+ + 0 0 0
Traditional par permanent	0	+ + + + +
Traditional par term	0	+ + 0 0 0
Adjustable premium permanent	0	+ + + + +
Indeterminate premium permanent	0	+ + + + +
Universal life flexible premium	0	+ + + + +
Universal life fixed premium	0	+ + + + +
Universal life fixed premium	0	+ + + + +
	Dump-in premiums allowed	

+ = Significant

0 = Insignificant

*LTC = Long term care insurance

LTD = Long term disability insurance

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

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

(i) Health insurance - LTC/LTD.

(ii) Traditional nonparticipating permanent life.

(iii) Traditional participating permanent life.

(iv) Adjustable premium permanent life.

(v) Indeterminate premium permanent life.

(vi) Universal life fixed premium.

The associated formula for determining the reserve interest rate adjustment must use a formula that reflects the ceding insurer's investment earnings and incorporates all realized and unrealized gains and losses reflected in the statutory statement. The following is an acceptable formula:

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

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
Y	is the same as X but for the prior year

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

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

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

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

(2) Notwithstanding subsection (1), an insurer subject to this section and sections 1125 and 1127 may, with the prior approval of the commissioner, take such reserve credit or establish such asset as the commissioner may consider consistent with this act.

(3) Agreements entered into after the effective date of this chapter that involve the reinsurance of business, excluding annually renewable reinsurance treaties and agreements, issued prior to the effective date of the agreements, along with any subsequent amendments thereto, shall be filed by the ceding insurer with the commissioner within 30 days from its date of execution. Each filing shall include data detailing the financial impact of the transaction. The ceding insurer's actuary who signs the financial statement actuarial opinion with respect to valuation of reserves shall consider this section and any applicable actuarial standards of practice when determining the proper credit in financial statements filed with the commissioner. The actuary should maintain adequate documentation and be prepared upon request to describe the actuarial work performed for inclusion in the financial statements and to demonstrate that the work conforms to this section. A foreign insurer is not required to file the agreements with the commissioner as required by this subsection if it is subject to filing requirements adopted by statute or regulation in its state of domicile that the commissioner has determined are substantially similar to those required under this subsection. 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 under aggregate write-ins for gains and losses in surplus in the capital and surplus account, and recognition of the surplus increase as income shall be reflected on a net of tax basis and identified as "reinsurance ceded" in the annual financial statement as earnings emerge from the business reinsured.

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