3. (3 points)

   a. (0.5 point)

      Briefly describe two reasons property-casualty insurers value being rated by rating agencies.

   b. (1 point)

      Provide two ways in which state regulators and A.M. Best differ in their evaluation of an insurer's capital adequacy.

   c. (1.5 points)

      Describe three procedures for monitoring insurer financial solvency, as recommended by the NAIC guidelines.

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3) **Sample Answer**

Part a

1. Some lines of business like, homeowners insurance are sometimes mandated by lenders to be purchased from highly rated insurers. Also, Insurers who write surety business may be required to maintain a certain rating to write business in certain states.
2. Ratings are important for insurers when selecting reinsurers to which to cede their business in order to ensure they select financially stable reinsurers who will not default.
3. A reinsurer needs a good rating in order to market itself to insurance companies as a financially stable company.
4. Agents are cautious of non-rated insurers
5. Third parties rely on outside sources to assess the financial strength of insurers.
6. Consumers don't have the knowledge to evaluate insurers. They need the help of the rating to select financially strong companies.
7. Investors rely on the ratings for their investment decisions.
8. Insurers financing cost (debt financing) reduces as rating strengthens.
9. A rating helps indicate the financial strength of an insurer and whether it can pay its claims, which would help increase its book of business.
10. Rating agencies are efficient at providing ratings, this saves insurers time, resources and significant expenses rather than them having to try to prove their own financial strength.
11. Insurers use the rating to identify areas of weakness within their company on which they can improve and improve their rating.

Part b

1) AM Best uses additional risk measures not found in RBC formulas like interest rate risk and catastrophe risk
2) While regulators utilize the RBC formula to determine total capital requirements, AM Best utilizes a 1% expected policy holder deficit (EPD) to determine capital needs.
3) RBC uses a worst case scenario approach for all risks, while AM Best uses a 1% EPD ratio for all risks.
4) State regulators mainly use the RBC quantitative formula. AM Best uses qualitative measures along with quantitative numbers (BCAR).
5) AM Best has a higher written premium charge relative to reserving than the RBC formula that state regulators depend on.
6) AM Best uses a higher asset risk in its formula of BCAR than what is used by state regulators in the RBC formula.

Part c

1) On site financial examinations - At least once every five years for full scope examinations. Limited scope examinations occur more frequent.
2) On-Site examinations- understand the company's risks and the ability to mitigate risks.
3) Calculate IRIS ratios that help indicate areas of concern for an insurer such as deficient reserves, high leverage ratios or unprofitable companies.
4) Apply IRIS ratios. If 4 or more of the ratios are out of the reasonable range regulators will monitor these insurers more closely.
5) Review RBS and IRIS ratios to identify companies that might be in financial trouble and prioritize the companies that need a more in-depth review.
6) Use of RBC formula – calculates minimum capital requirements and also keys framework for regulatory action.
7) Perform rehabilitation and liquidation of companies in need of such action.
8) Financial Analysis Working Group (FAWG) monitors solvency of nationally significant insurers to ensure nothing is missed in other monitoring techniques.
9) Require periodic financial reporting using standardized reports (SAP) to regulators.
10) Annual and Quarterly statements provide consistent and comparable reports between insurers and within an insurer over time.
11) Accreditation program which sets a minimum standard that insurers should follow to be accredited (eg laws, regulations, regulatory methods and department personnel) to improve the standards of maintaining financial solvency.

Examiner's Report

Part a.

Most candidates received full credit on this part. However, a common incorrect answer was: "insurers with a higher financial rating can charge higher premiums."

Part b.

Some candidates only provided an answer for AM Best or for the regulator; they did not contrast AM Best and the regulators. Common incorrect answers included "GAAP vs SAP" or "Going concern vs. Liquidation".

Part c.

Some candidates only gave a list type answer and did not fully describe the reasons.