18. (5 points)

Using the following information from an insurance company's 2011 NAIC Annual Statement (all figures are in thousands of dollars):

Bond Description	NAIC Designation	Actual Cost	Fair Value	Par Value	Amortized Cost
US Treasury Bonds	1	21,564	20,931	19,000	21,333
Regional Energy Company	3	15,541	14,965	15,000	15,498
Collateralized Mortgage Obligations	5	8,082	8,657	11,000	8,207
Total Bonds		45,187	44,553	45,000	45,037
Total Common Stocks		12,500	11,000		

Schedule P Part 1 - Totals	Direct and Assumed	Ceded
Loss Payments	40,150	6,000
Defense and Cost Containment Payments	3,550	375
Adjusting and Other Payments	3,741	150
Salvage and Subrogation Received	1,750	
Losses Unpaid		
Case Basis	34,400	7,200
Bulk + IBNR	13,200	5,600
Defense and Cost Containment Unpaid		
Case Basis	3,300	350
Bulk + IBNR	7,500	700
Adjusting and Other Unpaid	3,600	20
Salvage and Subrogation Anticipated	1,900	

Balance Sheet Items (assets are stated on an admitted basis)

Real Estate	
Properties occupied by the company	2,000
Properties held for the production of income	15,000
Properties held for sale	200
Cash	4,500
Net Deferred Tax Asset	10,000
Other Assets	2,300
Other Expenses	500
Ceded Reinsurance Premium Payable (net of ceding commissions)	400
Provision for Reinsurance	75
Common Capital Stock	400
Gross Paid In and Contributed Surplus	40,000

<<QUESTION 18 CONTINUED ON NEXT PAGE>>

18. (continued)

a. (4 points)

Construct the company's balance sheet as of December 31, 2011.

b. (1 point)

Discuss two items (other than loss reserves) in the company's balance sheet that could present a risk to the company's financial health.

CONTINUED ON NEXT PAGE

18) Sample Answer

Part A

US Treasury Bonds	21,333
Regional Energy Company	14,965
CMOs	8,207
Total	44,505
	Book/Adjusted
Common Stocks	Carrying Value
Total	11,000
ASSETS	
Bonds	44,505
Stocks	11,000
Real Estate	
Properties occupied by the company	2,000
Properties held for the production of income	15,000
Properties held for sale	200
Cash	4,500
Other Invested Assets	2,300
Net deferred tax asset	10,000
TOTALS	89,505
LIABILITIES, SURPLUS AND OTHER FUNDS	
Losses and Expenses Unpaid	
Gross	62,000
less Ceded	13,870
Net	48,130
Other expenses	500
Ceded Rensurance Premium Payable (net of ceding commissions)	400
Provision for Reinsurance	75
Total liabilities	49,105
Common Capital Staock	400
Gross paid in and contributed surplus	40,000
Surplus as regards policyholders	40,400
TOTALS	89,505

Part B

1. Collateralized mortgage obligations represent a relatively high percentage of the assets, and are subject to high volatility in value.
2. Common stocks represent a relatively high percentage of the assets, and are subject to high volatility in value.
3. The company has a substantial investment in low-grade bonds (NAIC Class 3 & 5), which have a relatively high risk of default.
4. Fixed income securities: in a high interest rate or high inflation environment, bond values would decline.
5. There is a constant potential for the devaluation of real estate, and thus lower statutory surplus.
6. Cash is a relatively small percentage of the total assets; a few large dollar claims could easily eat through this.

7. The company has a high percentage of its assets invested in real estate and CMOs, which are relatively illiquid, and a low percentage in cash.
8. The company's bond portfolio does not appear to be well-diversified, as it has a sizeable investment in a single corporate bond (Regional Energy Company).

Examiner's Report

a) Many candidates were able to identify the correct figures to enter on the balance sheet for common stock, real estate, and each category of bonds. Common errors made by a number of candidates included:

- Including the surplus accounts on the asset side of the balance sheet
- Including both paid and unpaid losses on the balance sheet
- Using gross (of reinsurance) unpaid losses instead of net
- Subtracting anticipated sal/sub from the Schedule P unpaid loss amounts (the Schedule P figures are already net of anticipated sal/sub)
- Defining total surplus as the difference between total assets and total liabilities PLUS the two surplus accounts.

b) There were several valid responses to this question related to the volatility or potential devaluation of the company's assets. Common candidate responses that did not receive full credit included:

- Gross Paid in and Contributed Surplus – a number of candidates believed the fact that most of the company's surplus is in this category (and not Unassigned Funds) to be a sign that the company is not profitable. However, the amount shown on the balance sheet is not an amount that was paid in during the current year – it is a cumulative amount to date. This amount could have remained unchanged since the formation of the company and the company could simply be paying out its profits as dividends on a regular basis.
- Net Deferred Tax Asset – the fact that this amount is admitted on a statutory basis (given) indicates that it is fairly certain to be recovered (see Blanchard, p.21).
- Ceded reinsurance/reinsurer solvency. There are no recoverables related to reinsurance shown on the balance sheet, so the only amounts at risk in the event of reinsurer insolvency are the ceded loss reserves. The candidate was asked to discuss two items *other than loss reserves*.
- Provision for Reinsurance – the amount shown on the balance sheet is very small. Even if it were underestimated significantly it would not be a risk to the company's financial health.
- Anticipated sal/sub – even if the company is unable to realize a significant portion of the anticipated amount, it would not represent a risk to the company's financial health.