6. (3.5 points)

An insurance company is licensed to write business in all states. Based on the initially calculated information below:

- RBC ratio: 210%
- IRIS ratio 1 (gross premiums written to policyholders' surplus): 750
- IRIS ratio 2 (net premiums written to policyholders' surplus): 350
- IRIS ratio 4 (surplus aid to policyholders' surplus): 20
- IRIS ratio 6 (investment yield): 5.0
- IRIS ratio 10 (gross agent's balances to policyholders' surplus): 35
- IRIS ratio 13 (estimated current reserve deficiency to policyholders' surplus): 22
- All other IRIS ratios are well within the acceptable ranges.

Evaluate the financial condition of the company and describe any actions that might be taken by the state regulator and by the NAIC.

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6. Sample Answers

Candidates were asked to evaluate the financial condition of the company:

RBC Ratio – 210% Healthy, no action necessary >200% assuming denominator ACL
IRIS Ratio 1 – 750 Healthy, this is a usual value since it is <900
IRIS Ratio 2 – 350 Unhealthy, usual value should be <300
IRIS Ratio 4 – 20 Unhealthy, usual value should be <15
IRIS Ratio 6 – 5 Healthy, usual value between 3 and 6.5
IRIS Ratio 10 – 35 Healthy, usual value <40
IRIS Ratio 13 – 22 Healthy, usual value <22

Since the company failed IRIS Ratio 4, then IRIS Ratios 1, 2, 10, and 13 should be recalculated excluding surplus aid:

#1 = 750 (1/.8) = 937.5 Unhealthy, >900
#2 = 350 (1/.8) = 437.5 Unhealthy, >300
#10 = 35 (1/.8) = 43.75 Unhealthy, >40
#13 = 22 (1/.8) = 27.5 Unhealthy, >35

Candidates were also asked to demonstrate knowledge of the actions that might be taken by the NAIC and the regulator. Common acceptable responses included any one of the following:

- Insurer might not have adequate reinsurance. NAIC can further investigate ratio 2 for affiliates, mix of product. Shorter tail line can afford higher ratio.
- NAIC will make sure that the company does not escape review, especially if nationally significant, and provide additional support during review if necessary.
- State regulator would look at the combined ratio; if it is >120% and since RBC ratio is between 200 -300% this would fail the trend test and the company would have to comply with the company action level of RBC model act.
- NAIC's Financial Analysis Division (FAD) should be involved, as this insurer writes business in all states => nationally significant insurers, by collaboration with state regulators in financial exam to ensure its solvency is not impaired.
- Results in 5 unusual IRIS ratios which is >4; therefore, requiring a higher priority level by NAIC analyst team in prioritization. State regulators might need to conduct an onsite financial exam since the off-site financial monitoring is showing potential concern.
- The regulator should consider reinsurance collectability with a high leverage ratio, regulators should also review profitability, mix of long-tailed versus short-tailed lines.
- The regulator should review the reinsurance contracts to see if any excessive commissions are being used to provide surplus aid.
- The company might be using ceding commissions from reinsurance contracts to inflate their surplus.
- Ratio 2 can indicate that company's reinsurance program can be inadequate, but this needs to be analyzed together with overall profitability and taking into account other factors such as if company writes long-tail or short-tail lines. Companies writing long-tail business need to maintain lower ratios.
- Surplus Aid = UEPR*(ceding com all)/(ceded prem all)
  The surplus aid is artificially inflating surplus.
- NAIC may monitor insurer through FAD and if condition worsens refer to FAWG.

6. Examiner's Report

This was a challenging question. Common errors included the following:

- Mentioning that 4 IRIS ratios need to be recalculated since IRIS 4 fails, but not recalculating the IRIS ratios. Also, some candidates multiplied the ratios by 1.2 rather than dividing them by 0.8.
- Mentioning that only ratios 1 and 2 need to be recalculated, rather than all ratios with surplus in the denominator
- Not mentioning that failing 4 ratios requires the state regulator to do a more extensive review
- Not discussing actions to be taken by NAIC and the state regulator if a company fails (or may fail) 4+ IRIS ratios
- Not distinguishing between actions of the NAIC and state regulators
- Incorrectly listing actions of the company rather than the NAIC or state regulator
- Not mentioning that the state regulator would need to do more extensive review before requiring a plan of action
- Mentioning surplus aid, but not explaining the cause of surplus aid as high ceding commissions to unearned premium
- Not knowing the correct thresholds for the IRIS ratios and/or not understanding their meaning
- Many candidates thought that the RBC ratio should be recalculated without surplus aid. The denominator of the RBC ratio is an estimate of required surplus based on factors such as asset risk, liability risk, etc, and does not include an adjustment for surplus aid. The RBC is evaluated by a trend test.
- Some candidates correctly identified that the trend test would apply since the RBC ratio is between 200% and 300%, but incorrectly referenced the 2-year operating ratio <120% or stated that the threshold was a combined ratio of 100% rather than 120%. The trend test requires the company to submit a plan of action if the current year combined ratio is >120%.

7. <u>Sample Answers</u>

a. Any three of the following:
    - Agent is cautious of non-rated insurer
    - It is an efficient way for the insurers to exhibit their financial strength, which is often required by customers
    - Bonds will sell easier and at a higher price to fund operations if company is rated highly
    - Banks may require a top-rated homeowner insurer prior to issuing mortgage
    - Courts may require top-rated insurer for structured settlements
    - Could obtain cheaper reinsurance with a high financial strength rating
    - Consumer may consider the rating when purchasing insurance
    - May allow them to enter surety lines (if rating >= A)
    - External evaluation of their financial strength to balance internal evaluations
    - Marketing – it can advertise its rating (if good) to get more buyers
    - To show its financial strength to regulators, policyholders, creditors
    - May lower borrowing costs
    - Underwriters & other parties often don't have the time, expertise, or resources to perform ratings themselves

b. Similarities (any one of the following):
    - Both of them are evaluating financial strength
    - They both use public financial statement information
    - Both result in public disclosure of financial strength ratings
    - Both use a capital model
    - In both situations the final ratings are determined by a rating committee instead of a rating