7. (2.75 points)

   a. (0.75 point)

      Briefly describe three reasons that obtaining a financial strength rating from a rating agency is beneficial for a mutual insurance company.

   b. (0.75 point)

      Identify one similarity and one difference between interactive ratings and public ratings.

   c. (0.5 point)

      Provide a rationale for why an insurance company actuary would disclose data to a rating agency that could potentially damage the insurer's reputation.

   d. (0.75 point)

      Identify a major insurance rating agency and defend the economic capital model it uses.

CONTINUED ON NEXT PAGE

- 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

analyst
- Both assign a "grade" to the insurer for comparison within the market
- They both affect the image of the company (affects business and investors)
- Both done by rating agencies
- Both ratings are based on the same scale

Differences (any one of the following – should compare interactive and public ratings):
- Interactive is much more costly and time consuming for the firm than public ratings
- An insurer presents additional proprietary data to a rating agency in an interactive rating and a public rating only uses public data
- Interactive requires participation of insurer, public does not

c. Any one of the following:
- One reason for disclosure is to provide transparency since the rating agency may suspect the insurer of hiding facts resulting in a more adverse rating than actually fair.
- Nondisclosure could be a far worse undertaking, as once the agency discovers (on its own) that data was concealed, it would very adversely affect the opinion of the agency on the financial stability of the insurer. It is far less damaging to provide any data necessary.
- The actuary is abiding by their ASOP's and need to display all data even if it could damage insurer's reputation.
- The actuary would want to disclose this because if the company fails it would reduce the credibility of the third party ratings. It is important for the ratings to be credible so people believe that they are an indicator of financial strength.
- A company wants its rating to be as accurate as possible. If this data would be disclosed at a later time, it might have a more significant impact on their rating.
- Integrity of insurer is a key factor in the qualitative rating. Having a problem come up that rating agent didn't know about can adversely affect ratings.

d. Any one of the following:
- AM Best (BCAR) Capital Model – this model is similar to RBC structure in that is assesses individual risks separately and combines them with a covariance adjustment.
  Benefits (any one of the following):
  - Similar to RBC so it's easier to understand than a stochastic model
  - Includes interest rate risk which is an improvement over RBC
  - Uses EPD of 1% which analyzes tail risk a bit more thoroughly than RBC's worst year approach

- S&P – Uses combination of accounting and company's own internal model. Company would know better the risks it faces and is best equipped to evaluate them.

- Moody's/Fitch uses a stochastic cash flow model which can better model the multivariate structure of insurance risks.

7. <u>Examiner's Report</u>

Parts a, b, and c were fairly straightforward and most candidates were able to respond using knowledge gained from the syllabus readings or their own experience. Part d was slightly more difficult in asking for candidates to defend a rating agency's capital model.

a. The first common issue was repetition of answers. For example, some candidates would say

“Certain lines of business require a high rating such as homeowners.” They would then also use “Surety requires a high rating to write.” Another example is the responses of “increases policyholder retention” and “increases new business.” These both fall under the larger heading of “policyholders use ratings to make decisions.”

The second common issue was vagueness. Many candidates said “third parties rely on ratings.” This, while true, does not give any information on which third parties or why they rely on ratings.

b. Some candidates provided generic similarities such as “they are both ratings.” This doesn’t provide any information that wasn’t already given in the question. Also, some candidates stated that public ratings were released to the public while interactive ratings are only used internally – this is incorrect.

c. Some candidates assumed that the choice was between total honesty by the actuary or a public rating. They then gave reasons why a public rating was inferior to an interactive rating.

d. One common issue on this part was a mismatch between the rating company named and the defense of their economic model. For instance a candidate may have named S&P but then defended AM Best’s model. There were also a number of candidates who would only describe the economic model but not defend it. Some candidates confused a rate organization with a rating agency and answered “ISO”. Finally, some candidates would describe and defend the qualitative portions of the rating method while ignoring the economic capital model.

8. <u>Sample Answers</u>

a. Any three of the following:
- Costs for expert evidence may increase (due to heightened scrutiny)
- More defendants are now involved in litigation
- Litigation is no longer routinely handled on a joint basis
- Many new defendants have abandoned settlement strategies
- Newer defendants are incurring significant discovery costs
- Coverage disputes may increase

b. Any three of the following:
- Defense costs have increased
- More defendants are now involved in litigation
- Litigation is no longer routinely handled on a joint basis
- Many new defendants have abandoned settlement strategies
- More focus/resources to seriously injured or severe claims
- Restrictions on non-malignancy claims
- Decrease in non-malignancy claims
- Increasing scrutiny of potentially fraudulent claims
- Restrictions on combination of claimants
- Venue reform
- Inactive dockets
- Medical criteria statutes
- Joint and several liability reform
- Challenges to validity of chest x-rays