

EXAM 6 – UNITED STATES, SPRING 2014

14. (5 points)

As part of the financial audit of an insurance company's 2012 Annual Statement, errors were found in the Balance Sheet and no errors were found in the Underwriting and Investment Exhibit or Schedule P. Given the following information (all figures are in thousands of dollars):

Underwriting and Investment Exhibit

Part 1A - Recapitulation of All Premiums

Line of Business	Amount Unearned (Running One Year or Less from Date of Policy)	Amount Unearned (Running More Than One Year from Date of Policy)	Earned But Unbilled Premium	Reserve for Rate Credits and Retrospective Adjustments Based on Experience
Totals	2,050	50	100	75

Part 1B - Premiums Written

	Direct Business	Reinsurance Assumed		Reinsurance Ceded	
		From Affiliates	From Non-Affiliates	To Affiliates	To Non-Affiliates
Totals	1,450	3,500	100	1,375	25

Schedule P

Part 1 - Summary

Years in Which Premiums Were Earned and Losses Were Incurred	Loss Payments		Defense and Cost Containment Payments		Adjusting and Other Payments		Salvage and Subrogation Received
	Direct and Assumed	Ceded	Direct and Assumed	Ceded	Direct and Assumed	Ceded	
Totals	22,600	4,600	2,100	300	1,800	100	900

Years in Which Premiums Were Earned and Losses Were Incurred	Losses Unpaid				Defense and Cost Containment Unpaid				Adjusting and Other Unpaid	
	Case Basis		Bulk + IBNR		Case Basis		Bulk + IBNR		Direct and Assumed	Ceded
	Direct and Assumed	Ceded	Direct and Assumed	Ceded	Direct and Assumed	Ceded	Direct and Assumed	Ceded		
Totals	4,400	1,000	5,300	1,050	500	60	1,100	120	500	1

All assets and liabilities from the Statutory Balance Sheet:

Cash and invested assets	13,385
Loss Reserve	7,600
LAE Reserve	1,800
Non-admitted assets	10
Accrued retrospective premium	100
Amounts recoverable from reinsurers	200
Ceded reinsurance premiums payable	30
Deferred premiums, agents' balances	250
Unearned premiums reserve	2,175
Reinsurance payable on paid losses	1,500
Uncollected premium and agents' balances	550

<<QUESTION 14 CONTINUED ON NEXT PAGE>>

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14. (continued)

a. (2.25 points)

Identify and correct the three Balance Sheet errors.

b. (1.75 points)

Using the corrected values from part a. above, calculate the company's total assets, total liabilities, and policyholders' surplus.

c. (1 point)

Based on the recalculated Balance Sheet items, calculate IRIS ratio 2 (net written premium to policyholders' surplus), and discuss how a regulator may respond to the result.

SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 14	
TOTAL POINT VALUE: 5.00	LEARNING OBJECTIVE: C1/C2
SAMPLE/ACCEPTED ANSWERS	
Part a: 2.25 point	
<ul style="list-style-type: none"> • Loss Reserve = Direct and Assumed Reserves (Unpaid Case + Bulk/IBNR) – Ceded Reserves (Unpaid Case + Bulk/IBNR) = (4,400 + 5,300) – (1,000 + 1,050) = 7,650 → Loss Reserve should be 7,650 • LAE Reserve = Direct and Assumed Reserves (DCC case + Bulk/IBNR + AO) – Ceded Reserves (DCC case + Bulk/IBNR + AO) = (500 + 1,100 + 500) – (60 + 120 + 1) = 1,919 → LAE Reserve should be 1,919 • Unearned Premium Reserve = 2,050 + 50 = 2,100 → UEPR should be 2,100 	
Part b: 1.75 point	
<ul style="list-style-type: none"> • Admitted Assets = Cash and invested assets + Accrued retrospective premium + Amounts recoverable from reinsurers + Deferred premiums, agents' balances + Uncollected premium and agents' balances = 13,385 + 100 + 200 + 250 + 550 = 14,485 • Liabilities = Loss Reserve + LAE Reserve + UEPR + Ceded reinsurance premiums payable + Reinsurance payable on paid losses = 7,650 + 1,919 + 2,100 + 30 + 1,500 = 13,199 • Surplus = Admitted Assets – Liabilities = 1,286 	
Part c: 1 point	
<ul style="list-style-type: none"> • Net Written Premium (NWP) = 1,450 + 3,500 + 100 – 1,375 – 25 = 3,650 • IRIS Ratio #2 = NWP / PHS = 3,650 / 1,286 = 284% which is less than 300% (not unusual) • While the ratio is in range, the regulator should note that the ratio is close to the unusual value threshold of 300% 	
EXAMINER'S REPORT	
<ul style="list-style-type: none"> • Very few candidates got full credit for this problem, although most candidates got significant partial credit in each of the three parts <ul style="list-style-type: none"> ○ Deductions were chiefly due to the inability to correct the misstated UEPR in part a), incorrectly identifying assets or liabilities in part b) and/or failing to discuss the regulators response to the calculated IRIS Ratio in part c) • The only part of the question that included the synthesis of concepts or papers was part c) where candidates were asked to discuss the regulator's response to the calculated IRIS ratio. In this case, a synthesis of several concepts or papers could have been applied and a wide variety of supported responses were given full credit. 	
Part a	
<ul style="list-style-type: none"> • Candidates had to identify and correct the misstated Loss, LAE and unearned premium reserves to receive full credit for this part. • Candidates generally performed well in identifying and correcting the Loss and LAE Reserve. While many candidates could identify the UEPR as being incorrectly stated on the Statutory Balance Sheet, the most common error on part a) was to incorrectly calculate the UEPR. Many candidates incorrectly included Earned but Unbilled Premium and/or the Reserve for Rate Credits and Retrospective Adjustments Based on Experience in the calculation for UEPR (either through addition or subtraction). <ul style="list-style-type: none"> ○ A smaller number of candidates incorrectly identified other items, notably the accrued retrospective premium, as being incorrectly stated on the Statutory Balance Sheet 	

SAMPLE ANSWERS AND EXAMINER'S REPORT

- A small number of candidates did not include AO reserves when calculating the corrected LAE Reserves

Part b

- While many candidates received partial credit on this part, a majority were not able to correctly identify all correct components of the assets and liabilities. Candidates had to correctly calculate the asset, liability and surplus to receive full credit for this part.
- Common errors included:
 - Including liabilities as assets or assets as liabilities
 - Altogether leaving off balance sheet items listed on the Statutory Balance Sheet (with the exception of non-admitted assets) or including amounts from the Underwriting and Investment Exhibit
 - Failing to bring down corrected responses from part a) to part b)
 - Because the problem was not specific, supportable treatments of non-admitted assets were accepted. However, some candidates included non-admitted assets in the asset total but did not remove them when calculating the surplus and therefore did not receive full credit.

Part c

- Candidates were expected to correctly calculate the net written premium, calculate the IRIS Ratio, compare it to the threshold value of 300% (or at least clearly state a pass/fail for the test), and discuss how the regulator would respond to the calculated IRIS ratio to receive full credit for this part.
- The most common error for part c) was to fail to provide a regulator response. A variety of supported answers were accepted here. Candidates that addressed potential insurer responses (such as "increase surplus") were not awarded credit.
 - Many candidates calculated IRIS Ratio #2 as being above 300% due to the surplus they calculated in part b). In these instances, credit was awarded to candidates that provided a reasonable possible response from the regulator given that IRIS Ratio #2 had an unusual value. Some accepted possible responses included:
 - Look at GWP / PHS or examine IRIS Ratio #2 for the group due to the high level of affiliate business
 - Look at the mix of long and short tail business (short tail can sustain higher ratios)
 - Look at profitability of company (more profitability can sustain higher ratios)
 - Look at financial strength of reinsurers and/or examine the adequacy of the reinsurance program