

22. (1.25 points)

a. (0.75 point)

Briefly describe three adjustments necessary to restate an insurance company's statutory loss reserves to a fair value basis.

b. (0.5 point)

Under an economic environment of very low investment yields, explain whether the fair value of loss reserves is likely to be higher or lower than loss reserves recorded on a statutory accounting basis.

## SAMPLE ANSWERS AND EXAMINER'S REPORT

<b>QUESTION: 22</b>	
<b>TOTAL POINT VALUE: 1.25</b>	<b>LEARNING OBJECTIVE: C3</b>
<b>SAMPLE/ACCEPTED ANSWERS</b>	
<b>Part a: 0.75 point</b>	
<ul style="list-style-type: none"> <li>• Incorporate cash flows for the cost of capital</li> <li>• Use payout pattern and risk free rate to discount cash flows</li> <li>• Incorporate illiquidity adjustment into discounting</li> <li>• Calculate unbiased estimate of expected payments</li> <li>• Calculate adjustment for time value of money</li> <li>• Calculate margin for adverse development</li> </ul>	
<b>Part b: 0.5 point</b>	
<p>With very low investment yields, the discount factor is very small. After adding the risk margin you may end up with a higher reserve than SAP reserve.</p> <p>Higher than statutory. Discount will be minimal which and unlikely to be bigger than the effect of adding the margin and calculating non-deficient estimated reserves.</p> <p>The fair value will be higher than stat basis reserves since investors need some return on top of the discounted reserves. Since the investment yields are low, the present value of this return is high and will bring the fair value of reserves up.</p>	
<b>EXAMINER'S REPORT</b>	
<p>The candidates were expected to know what adjustments are needed to loss reserve liabilities under the fair value accounting paradigm and how the risk margin impacts the reserves in fair value accounting.</p> <p>This question was intended to test candidate's basic understanding of fair value accounting.</p>	
<b>Part a</b>	
<p>Most candidates wrote a list for part this subpart. The question explicitly asked for candidates to briefly describe their responses. Candidates that provided a list for their response, e.g. "discount", did not receive credit. Rather, a fuller answer was expected to demonstrate knowledge of the material, such as "Discount the unbiased reserve for time value of money using a risk-free rate, duration-matched to the payout of the liabilities". As indicated in the sample/accepted answers, we accepted much shorter versions than that provided in this example. However, a more fuller response than a one to two word list was expected.</p> <p>A handful of candidates wrote adjustments to other items to the balance sheet which were incorrect.</p>	
<b>Part b</b>	
<p>Candidates needed to justify their "higher" response. Without justification, no credit was awarded.</p> <p>Only writing "higher" did not receive credit because it did not demonstrate knowledge;</p>	