11. (2.5 points)

a. (0.5 point)

For each of the following stakeholders, briefly describe one need that is not met by the data shown in the Statement of Income:

- Regulators
- Company management

b. (0.5 point)

Briefly describe two differences between the expense information shown in the Insurance Expense Exhibit (IEE) and the Underwriting and Investment Exhibit.

c. (0.5 point)

Provide one argument for and one argument against excluding unrealized capital gains and losses from the total investment gain allocated in the IEE.

d. (1 point)

Describe two differences between the NAIC's prescribed method of allocating surplus in the IEE and methods of allocating surplus that might be used for ratemaking purposes.

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QUESTION 11	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: C1**
SAMPLE ANSWERS	
Part a: 0.5 point	

Unmet need for Regulator:
- Need to determine if premium rates by LOB are inadequate or excessive
- Surplus by LOB to evaluate solvency at the individual line level
- Need to understand qualitative data such as quality of management or management's business plan
- Evaluation of company's market conduct and/or trade practices

Unmet need for Company Management:
- Need to determine which lines of business / segments / regions of the company are profitable
- Capital allocation by LOB to evaluate risk-adjusted performance
- Income Statement is on a SAP basis. Management may want to see data on a GAAP basis to better evaluate the company as a going concern
- There is a mismatch between premiums and losses in the Income Statement. Management may want to see accident year data to better evaluate loss exposure.
- Management may want to view results using discounted reserves to get a better measure of profit.
- Split LAE into DCC and A&O to see where expenses are coming from
- Need to understand how legal changes in the market may affect the company
- Need to assess future profitability, not just today's profitability

Unmet need for either Regulator or Management (acceptable for either):
- Need to calculate IRIS ratios / RBC to evaluate solvency risk
- Premium by LOB to watch for any lines that have abnormally high premium growth
- Need to assess collectability of reinsurance
- Need details on assets/investments to evaluate quality of assets/investments
- Need to know if reserves are adequate and do not have a high risk of adverse development
- Need to evaluate liquidity risk by seeing size/type of unrealized gains
- Need to know income by line of business

Part b: 0.5 point

Any two of the following:
- IEE includes expenses by LOB
- IEE further allocates underwriting expenses into three components: 1. Acquisition, field supervision and collection expenses, 2. General expenses, 3. Taxes, licenses and fees
- U&IE has total expense PAID calculated (Paid, unpaid, & incurred amounts), IEE has incurred figures only
- U&IE is to the dollar, IEE is in thousands
- IEE has direct and net breakouts, U&IE only has net
- IEE shows dollars and percentages, U&IE only shows dollars
- U&IE only allocates LAE reserve to line, while IEE allocates all expenses to line

• U&IE has Reinsurance assumed divided between property, liability, and financial lines • IEE has the following lines broken down into components: Allied lines, CMP, Auto physical damage • U&IE has Medical Professional liability and/or product liability broken up between Occurrence & claims made • IEE breaks LAE into DCC & A&O, U&IE does not
Part c: 0.5 point
For excluding: • Unrealized capital gains are excluded because they are a direct credit or charge to surplus and don't flow through the income statement. Consistent with Statement of Income. • Unrealized gains can be volatile/uncertain – including would increase the variability/uncertainty of income • Unrealized gains may not be readily available since the assets must be sold first • Not appropriate for bonds. Any price changes are not meaningful if the company intends to hold to maturity. For including: • The inclusion of only realized capital gains in investment income often distorts profitability measurements that are motivated by taxes and cash needs. • Including unrealized gains would provide a more complete picture of investment performance / profitability • The assets will be sold eventually, so including them would be closer to the "going concern" view of GAAP, and more realistic. • If they are not included, it can be difficult to compare investment results of different companies. Most non-insurance companies are on a GAAP basis.
Part d: 1 point
Difference 1: • The IEE uses a retrospective method • Ratemaking methods are prospective Difference 2: • The IEE allocates surplus by loss reserves, unearned premium reserves, and earned premium for each line of business / IEE allocates by formula • Ratemaking may use different allocation methods to better allocate surplus to inherent risk of the line, such as accounting for catastrophe exposure in homeowners insurance Difference 3: • NAIC prescribes to what line of business surplus should be allocated to on a companywide basis • Ratemaking may allocate surplus to either more granular levels or broader levels, such as by coverage (example: liability and physical damage separate), or by state or geography Difference 4: • NAIC allocates all actual surplus to lines of business • The summation of the allocated surplus may not equal the total surplus in

ratemaking
EXAMINER'S REPORT
Part a
Candidates generally performed well on this part, as they could draw upon any need by regulators or company management that couldn't be derived from the Statement of Income. Common errors: • Listing an item not found on the Statement of Income with no description of the need by the various stakeholders • Stating that policyholder surplus is not found on the Statement of Income • Stating that a stakeholder needs to look at historical changes over past years – but the Income Statement already provides this info (has both current and prior year information, and multiple Income Statements could be used for a more extensive history)
Part b
In general candidates struggled to provide two differences. Common errors: • Listing difference for items other than expenses • Not giving enough detail on differences. Merely stating that the breakouts for expenses are different between the two was not sufficient. • Stating that one of the exhibits has a breakout by state (neither does) • Stating that one of the exhibits list expense by category and the other does not (both do)
Part c
This part was more challenging, but many candidates were able to successfully synthesize information from various parts of the syllabus to develop one argument for and one argument against excluding unrealized capital gains. Common errors: • Stating that unrealized gains should be included because they are in surplus. • Being too general, e.g., "Unrealized gains should not be included because they are not realized." • Unrealized gains are difficult to allocate, so they should be excluded (realized gains are an artificial allocation as well)
Part d
The question has the keyword "describe", and is worth 1.0 for two differences. Therefore, for each difference the candidate must present information on both allocation methods to receive full credit. Candidates generally excelled on the NAIC/IEE allocation method and struggled on the ratemaking allocation of surplus. For the ratemaking allocation, candidates needed to demonstrate that they understood that surplus allocation is based on risk. Common errors: • Only describing what one method does without describing the other, for example, "ratemaking considers the inherent risk of each LOB while the IEE does not" • For Ratemaking, being too vague, not talking about risk and only providing one example of what ratemaking would consider