2. (2 points)

   Consider the following statement: Financial rating agencies have implicit regulatory power over insurance companies.

   a. (1 point)

      Discuss two reasons why this statement has merit.

   b. (1 point)

      Discuss two arguments against this statement.

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QUESTION 2	
TOTAL POINT VALUE: 2.0	**LEARNING OBJECTIVE: A1 / A3**
SAMPLE ANSWERS (BY PART, AS APPLICABLE)	
Part a: 1 point	

The following provides examples of thorough responses having the necessary components to demonstrate knowledge of the topic and obtain full credit:

- Insurers are motivated to have high ratings in order to attract policyholders, so will adjust operations/business strategies to ensure their rating is high

  Some banks require homeowners to be placed with insurers above a certain rating in order to get a mortgage so the rating agency has implicit power in deciding which insurers qualify

- Certain types of insurance (e.g. surety, structured settlements) may need to be purchased from highly rated insurers. This means if you don't get a certain financial rating you may be limited in what you can write.

  Lower rated insurers and reinsurers may be avoided by agents and reinsureds, so there is high pressure to perform well and do certain actions to maintain a high rating.

- Because financial ratings are important to insurers in terms of selling business via agents and brokers, the rating agencies can indirectly pressure insurers to take actions and be financially strong due to fear of downgrade in ratings. Agents and brokers might be hesitant to place business with an insurer that does not have a good rating

  In conducting off-site solvency monitoring of insurers, regulators may reference the financial strength ratings. Since regulatory scrutiny is undesirable to insurers they may be pressured to keep a good rating, thus giving rating agencies some power.

Part b: 1 point

The following provides examples of responses having the necessary components to demonstrate knowledge of the topic and obtain full credit:

- It is not required that the insurer receive a financial strength rating, so any sense of regulatory power the agencies have is not universal and absolute.

  Rating agencies cannot intervene and take corrective action against an insurer and so have no real regulatory power over the insurers.

- Insurance companies pay for ratings so there is some chance of moral hazard for rating agencies giving higher than actual deserved rating to obtain market share. This contradicts regulators goal in maintaining an insurer's solvency.

  There are multiple rating agencies and an insurer does not have to do business with one particular agency. With regulators, the company cannot choose.

- Rating agencies cannot require the company to make specific changes, which regulators can ultimately do.

  Ratings reflect more on financial position of the company rather than solvency. Rating agencies focus is more of an on-going concern.

EXAMINER'S REPORT (BY PART, AS APPLICABLE)

Candidates were expected to demonstrate an understanding of the differences and similarities between insurance company relations with rating agencies and regulators. Candidates should be able to demonstrate why rating agencies have implicit regulatory powers over insurance companies, and also identify why the rating agencies do not have any actual regulatory power over insurance companies.

Overall, most candidates did not receive full credit on both parts but were able to obtain at least partial credit on each part, with many candidates receiving more points on part a. In part b, many candidates seemed to find difficulty in stating two complete and unrelated thoughts. In order to receive full credit on each part, candidates were expected to make two complete statements, consisting of two thoughts each.

Common errors included:

- Restating the same idea for each statement.
- Asserting only one thought, or incomplete thoughts in each statement.
- Not identifying the explicit powers that a rating agency lacks but a regulator does not.

Part a

Most candidates performed well on this part of the question. The candidate was expected to identify the benefits of cooperating with rating agencies, and express the business reasons that would make cooperation with the rating agency virtually mandatory. Also acceptable was the ability to demonstrate the ways in which not cooperating with a rating agency can be similarly detrimental to not cooperating with regulators. In order to receive credit for this part, the candidate was expected to list two complete statements, each consisting of two thoughts demonstrating an understanding of the question.

Common errors on this part:

- Incomplete or singular thoughts in each statement. For example, "Agents may require a high rating."
- Repeating the same idea for each statement within this subpart.
- Stating that agencies perform on-site evaluations. This response does not indicate regulatory power over insurers.

Part b

This part of the question was more challenging for candidates. To obtain full credit, candidates were expected to identify the explicit powers rating agencies do not have over insurers that the regulators do possess and/or identify the differences between the goal of the rating agency compared to that of the regulator. Similar to part a, candidates were expected to list two complete statements, each consisting of two thoughts demonstrating an understanding of the question.

Common errors on this part:

- Including only one thought in each statement provided.
- Providing responses that do not indicate why a rating agency would not have implicit authority over insurers. Common responses for this included:
  - Claiming that guaranty funds negate the need for financial ratings
  - Some candidates claimed that because rating agency methodologies may be unclear they do not have implicit authority.
  - Stating that the financial collapse led to less credibility for rating agencies.