

EXAM 6 – UNITED STATES, SPRING 2015

5. (3.25 points)

During the last several years, a multi-state insurer has experienced rapid growth in written premium and an increase in its underwriting expense ratio.

a. (0.5 point)

Explain why a regulator might be concerned with the financial health of the company.

b. (1 point)

Briefly describe two IRIS ratios that should be investigated and their relevance to this situation.

c. (0.5 point)

The regulator in the company's state of domicile has not yet decided to examine the company. Briefly describe two options that are available to non-domiciliary regulators to assess the insurer's financial health.

d. (0.75 point)

Fully describe the NAIC accreditation program.

e. (0.5 point)

Describe the extent to which the accreditation process may be relevant to the situation described in part c. above.

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## SAMPLE ANSWERS AND EXAMINER'S REPORT

<b>QUESTION 5</b>	
<b>TOTAL POINT VALUE: 3.25</b>	<b>LEARNING OBJECTIVE: A2</b>
<b>SAMPLE ANSWERS (BY PART, AS APPLICABLE)</b>	
<b>Part a: 0.5 point</b>	
<p>The following provide examples of thorough responses having the necessary components to demonstrate knowledge of the topic and obtain full credit; any one of the following was accepted:</p> <ul style="list-style-type: none"> <li>• Often, rapid growth indicates the insurer may be relaxing its U/W standards or rates to grow the business. This decreases the margin of error to stay profitable. Furthermore, a high expense ratio leaves less money to pay for claims, increasing insolvency risk.</li> <li>• The insurer most likely does not have as much insight into the new business being written. Also, due to economies of scale it seems counter-intuitive for expenses to increase -&gt; may be writing more premium to cover costs.</li> <li>• (i) insurers in poor financial health may try to grow premiums to pay past losses (ii) one would expect due to economies of scale u/w expense ratios to decrease with increase premiums. Something strange may be going on.</li> <li>• Rapid growth is a leading cause of insolvency. Increasing expense ratio and growing book magnify potential profitability risk.</li> <li>• Rapid growth is concerning because insurers don't know about the growing business risks right away/not as much insight as in "steady state." Also, reserving methods would need to be adjusted because data skewed towards end of year. Reserving actuaries may miss this. Also, increasing u/w expense ratio -&gt; less profit -&gt; chances for insolvency if no rate action.</li> <li>• Rapid growth is often a precursor to insolvency, as company may cut rates to try to get premium in the books to get cash in the door to pay its obligations. Rate cutting exacerbates an already bad financial situation by making rates potentially inadequate. Increase in the u/w expense ratio will indicate that the company may also be paying higher commissions to agents to try to get business on the books, which puts further pressure on profitability.</li> <li>• Rapid growth may be caused by inadequate rates. Combined with high u/w expense ratio, the insurer may have profitability issues.</li> <li>• Rapid premium growth is a leading indicator of insurer insolvencies. Additionally, the increasing expense ratio may indicate the company is no longer profitable, which could result in declining surplus</li> </ul>	
<b>Part b: 1.0 point</b>	
<ul style="list-style-type: none"> <li>• -Change in NWP / Prior NWP - This shows the amount the net premiums increased from prior values. This is relevant because if the premium rapidly increases this may fall above the trigger of 33%.</li> <li>• -2yr Operating Profit - If the company is profitable, an increase in WP is less of an issue as long as they are reserved properly.</li> <li>• -IRIS ratio 3 – change in net written premium over prior year NWP. This is relevant because there has been a lot of written premium growth.</li> <li>• -IRIS ratio 5 – 2 year operating ratio. (2 yr loss and LAE and pol dividends / 2 yr earned premium + 2 yr expense ratio – other income / 2 yr written premium – 2 yr investment income / written premium.) - This is relevant because of the increase in expenses may</li> </ul>	

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produce an unhealthy ratio > 100%

- -IRIS ratio 5- 2yr overall operating ratio -> should be investigated to see if the company is profitable (given its increasing expense ratio). This usual range is <100%  
-IRIS Ratio 13 - Estimated Current Reserve Deficiency / PHS -> the usual range is <25%. Should be investigated to determine reserve adequacy. Poor reserve adequacy in a time of rapid growth is a red flag that the company may be trying to increase written premium in order to pay current claims.
- -2 year operating ratio -> see if it's less than 100% -> see if insurer is still profitable despite rapid growth + higher u/w expense ratio  
-1 year reserve development -> see if greater than 20%. If yes, then concerns that reserve might be inadequate w/ growing book.
- -IRIS Ratio 1 (GWP to PHS) - An increase in this ratio could indicate that the insurer is bearing more risk relative to its policy holder surplus  
-IRIS Ratio 5 (Two Year Operating Ratio) - An increase in this ratio could signal profitability problems, and profitability is a principle determinant of the insurer's financial stability and solvency.
- -Look at the Net Written Premium to surplus (ratio 2) in order to see if the insurer is maintaining adequate reinsurance. Growth may not be as much of a concern if it is accompanied by good reinsurance.  
-Look at the adjusted liabilities to liquid asset ratio to determine the liquidity of the insurer. A change in this ratio could be a sign of problems meeting demands for cash.
- -NWP to PHS - An increase in this ratio could indicate that the insurer is bearing more risk relative to its policy holder surplus  
-Two Year Operation Ratio - An increase to over 100 % might indicate the rapid growth is due to higher commissions paid to attract new business.
- Ratio 11 – 1 yr reserve development – helps determine reserve adequacy. A high ratio suggests under-reserving, which is a more severe problem associated with premium growth.  
Ratio 2 – NWP:PHS – shows how much risk the company is keeping and how dependent they are on reinsurance. Rapid premium growth may not be an issue if there are adequate reinsurance contracts in place.
- Ratio 13 – Estimated reserve deficiency to PHS since we want to see if reserves are adequate. If growing rapidly to see if cash demands and reserves are inadequate it would mean the situation is even worse. High insolvency risk since this is a short term solution.  
Ratio 9 – Adjusted Liab/Liquid Assets – want to see if assets are liquid enough to meet demands and see potential outlook for policyholders if liquidated. Since rapid growth may mean premiums deficient so assets would be used to meet obligations
- IRIS 2 – New Written Premium to Policyholder Surplus. If the insurer has substantial PHS, it may be acceptable to be growing  
IRIS 12 – 2-yr reserve development. The insurer has been growing for several years, so we'll want to be sure they understand the business and are accurately reserving for it.

### **Part c: 0.5 point**

- Non-domiciliary regulators can still examine the company's financials, and will still examine them if the insurer operates in their state. The regulators can urge the domiciliary regulator to act. This is the peer pressure function of the regulatory system which

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counters forbearance.

- Other regulators can order examinations on their own (single-state effort, multi-state effort that doesn't involve the NAIC. Outside regulator could also pressure domestic regulator to take action.
- -Can review public financial statements to calculate IRIS ratios and RBC ratios, as well as review income statement and balance sheet to help determine if the insurer is troubled.  
-Check rating from financial rating agency. Has it changed during the last several years?
- -The outside regulator may conduct its own review; the insurer is subject to regulation by any state in which it operates, regardless of whether the insurer is a foreign, domestic, or alien operator.  
-If the company is a nationally significant insurer, then the outside regulator could rely on findings from the review by the NAIC's Financial Analysis Division.
- -Pressure the domiciliary regulator to examine the company  
-Examine the company themselves
- -Non-domiciliary states are required to license insurers in their state and may assess an insurer's financial position when it applies for a license
- -They could do their own financial exam to evaluate solvency.  
-They could use NAIC's monitoring and assessment tools and possibly ask the NAIC for help (e.g. refer the insurer to FAWG if it has not already been caught through the FAD's periodic analysis as being of concern.)

### Part d: 0.75 point

- The NAIC accreditation program looks at the laws and regulations of the state, regulatory methods and department/personnel procedures to make sure they are meeting minimum standards and are efficient.
- NAIC accreditation program serves to provide more uniform regulation among the states to help facilitate and improve state regulation. It does this by requiring states' laws and regulations meet the basic standards of NAIC model laws. It looks to make sure the state practices and procedures are acceptable and that state has the authority to impose sanctions and take regulatory action. It also makes sure that the organizational structure and personnel of DOI are adequate.
- Accreditation program sets minimum standards for DOI solvency regulation such that other states can rely on that DOI's regulatory practice related to multistate risks. It ensures states have statutes/regs that meet minimum standards related to NAIC model laws pertaining to Insurer solvency requirements and DOI monitoring. Also ensures DOIs practices are adequate and methods are acceptable. NAIC evaluates DOIs on site every 5 years with offsite reviews every year by looking at samples of DOIs financial solvency and monitoring exam work on multi-state risks.
- The NAIC accredits state DOIs to ensure that states' regulatory systems are somewhat uniform and qualified to regulate the insurance industry. The NAIC looks at state laws and regulations, past financial exams from the ODI, and DOI practices.
- Purpose: to create minimum standard for solvency regulation. Once accredited, provides evidence that state has regulatory system that can be relied upon by other states. To be qualified need minimum regulatory law. Currently all states are accredited.
- A program that grants accreditation to state regulatory bodies if they meet certain criteria of the NAIC. A review by the NAIC is performed, which consists of a legislative review,

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<p>personnel interviews, and regulatory practices.</p> <ul style="list-style-type: none"><li>• A company makes a request to the NAIC to become accredited. The NAIC performs an on-site exam every five years, and an annual off-site exam. The team either accredits the state or provides a management comment letter that contains suggestions for improving the system of financial regulation.</li><li>• NAIC looks at several aspects of regulator: personnel, org structure, laws, licensing procedures, financial analysis procedures. Reviews on-site every five years. Makes sure up to their standards.</li></ul>
<p><b>Part e: 0.5 point</b></p> <ul style="list-style-type: none"><li>• NAIC accreditation process facilitates information sharing among states. It provides a forum for communication. This can be used by non-domiciliary states to pressure the domiciliary states regulators to take action.</li><li>• NAIC accreditation promotes uniform reporting and accounting standards, which makes it easier for different state regulators to review one insurer's financial condition.</li><li>• State of domicile may not be accredited but if it is, may be at risk of losing accreditation for not investigating rapid growth insurer if certain indicators exhibit a troublesome financial situation.</li><li>• If the state of domicile is not accredited, then the other states will not have as much confidence in its ability to be effective in regulating solvency.</li><li>• If the domiciliary state is accredited, the state should have a process for identifying troubled insurers. If the domiciliary state is NOT accredited, it's probably more likely that the non-domiciliary state would want to interfere via the options described in part c.</li><li>• The accreditation process is not relevant here. The purpose of accreditation is to evaluate DOIs, not address specific company situations.</li><li>• The accreditation process provides an avenue for non-domiciliary states to pressure the domiciliary regulator into performing an examination of the company</li><li>• Due to the accreditation process, states have similar regulation standards. If the non-domiciliary regulators find any problems about this company, they can share this information with the domiciliary regulator and pressure them to take action.</li><li>• If the domiciliary state doesn't want to lose accreditation, then they should perform a review.</li><li>• The regulator may not have examined the insurer because it lacks the resources to do so. Sufficient resources is a requirement of NAIC accreditation, and this may result in the DOI losing its accreditation.</li><li>• If the state is NAIC accredited, non-domiciliary states may have more confidence in the dom. State's regulatory process. It may feel that exam wasn't conducted as it wasn't deemed necessary, which means insurer is in good shape.</li><li>• Non-domiciliary states can be assured that the domiciliary state is using similar criteria to assess the company's financial health that they would use.</li><li>• Since the states must satisfy the same accreditation requirements, the other state regulators can usually trust the state's processes. However, a system of peer review is in place, so regulators from other states could pressure the domiciliary state to act.</li></ul>
<p><b>EXAMINER'S REPORT (BY PART, AS APPLICABLE)</b></p>
<p>This question asks about programs, tools, and other options available to state insurance regulators. The Insurance Regulatory Information System (IRIS) and the Accreditation Program are specifically</p>

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mentioned, though the question also asks the candidate to identify other options available to regulators as well. Candidates are expected to be able to identify and describe a variety of options available to state regulators, although the level of detail which a candidate is expected to know varies by program.

The IRIS ratios are discussed by name several times on the syllabus and covered in detail in multiple syllabus readings, one of which is solely focused on IRIS ratios. Therefore, candidates are expected to have substantial knowledge of the IRIS system, including names, descriptions, and purposes of a number of IRIS ratios.

Candidates are expected to be familiar at a higher level with other programs and tools available to state regulators. Candidates should be able to identify some of these other options, and should be able to demonstrate an understanding of the goals and general process of these programs, including the Accreditation Program.

Finally, candidates are expected to be able to apply knowledge of each of these programs to real-world examples.

Some parts of this problem require basic knowledge of financial warning signs, solvency regulation, and/or NAIC programs. Part e is more challenging, as it requires the application of syllabus material to a real-world situation.

Candidates performed quite well on this question, though most candidates did not receive full credit. Many candidates skipped one or more parts of this five-part problem, especially part e. Further, many candidates provided only partial answers for parts a or d. Additionally, this problem asked for a large number of details, and many candidates answered the question well but made one more small mistakes on an individual part. This was especially true on part b.

For more detail, please see the commentary by part below.

### **Part a**

The candidate was expected to identify why written premium growth and underwriting expense growth may be a concern; the candidate could also answer that rapid growth is a leading indicator of insolvency and why. To receive full credit, candidates were expected to provide two distinct ideas.

Only a basic understanding of solvency concerns was necessary to be successful on this part, so most candidates did well on this portion of the question.

Common errors include:

- Not providing two reasons why there might be concern
- Providing basic regulator concerns with solvency that are too general and not related the company in the question

### **Part b**

Candidates were expected to define two different ratios and explain why each ratio is relevant to the situation stated in the question. Given the wording of the question, any IRIS ratio was an acceptable answer as long as the candidate provided its relevance to the situation or tied the ratio to the response in Part a.

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Given that IRIS ratios are heavily emphasized in the syllabus, candidates generally did well on this part.

Common errors include:

- Not fully explaining why the ratio is relevant to the specific situation given in the question
- Providing only the number of the IRIS ratio without any further definition
- Not correctly defining the ratio

### Part c

Candidates had a wide variety of syllabus material from which to pull answers to part c, so candidates were expected to be able to provide two distinct options for the non-domiciliary state to pursue.

Candidates generally scored well on this section of the question, with the most common score being full credit.

Common errors include:

- Providing two examples of reviewing financial information
- Citing functions of the NAIC that do not apply to the review of insurers

### Part d

This question asks about the NAIC's Accreditation Program, which is discussed in several different syllabus readings. Candidates are expected to be able to demonstrate basic knowledge about this program, demonstrating knowledge of one or more of the following: the goals of the Program, what elements are included in the review process, who are the key participants in the Program, and/or implications of states being accredited. As seen in the list of answers above, not all of these items needed to be discussed, but candidates needed to touch on enough individual aspects of the program to receive full credit.

This question could be answered successfully with basic knowledge of the Accreditation Program. Generally candidates performed well on this part, with the most common score being full credit.

Common errors include:

- Not providing sufficiently detailed responses (e.g. "Program ensures that DOI meets standards" is not specific enough.)
- Stating that the Accreditation Program is for insurers, rather than Departments of Insurance.

### Part e

This question asks the candidate to link the Accreditation process to the "situation" in part c of the problem. Candidates are expected to be able to demonstrate basic knowledge about this process, and apply this knowledge to real-world or theoretical situations.

The "situation" noted in this subpart could refer to any of: (a) a domiciliary state that has not performed an examination of a potentially troubled company, (b) a non-domiciliary state that has identified a problematic company in another state, or (c) the interaction between two different state regulators of a multi-state company.

This subpart is the most difficult part of Question 5, requiring candidates to synthesize information from the syllabus readings and apply it to a real-world situation. However, the open-ended nature of the question meant that a wide variety of answers were determined to be acceptable. As a result, candidates performed well on this problem, and the most common score was full credit. Some candidates, however, performed well on other parts but did not attempt this part.

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Common errors include:

- Failure to link the answer to the situation in part c (e.g. listing an unrelated aspect of the Accreditation process without making its relevance to the question clear.)
- Stating that the accreditation is not relevant to the situation without providing an explanation why.
- Writing an answer that implied that the Accreditation Program is for insurers, rather than Departments of Insurance.
- Implying that the accreditation status of one state's DOI impacts what actions are required of, or available to, another state's DOI.