6. (3 points)

It has been discovered that a chemical contained in office chairs emits odorless, noxious fumes that cause terminal illness after 10 years of exposure. Recently, the first court to review coverage has found that a standard commercial general liability policy will cover this environmental liability exposure.

a. (1 point)

Assume that many insurance companies become technically insolvent as a result of this mass tort exposure. However, one company has recognized only 10% of the exposure of other companies with a similar size and mix of business.

Describe how a rating agency might assess this company for financial rating purposes, and briefly describe why IRIS ratios 1 and 11 should be reviewed.

b. (1 point)

A reinsurer's rating is downgraded from A to BBB by A.M. Best as a result of the reinsurer's need to increase reserves by $1 billion to cover the chair exposure. Discuss two negative business consequences to reinsureds that may result from the rating downgrade of the reinsurer.

c. (1 point)

Assume a national settlement is reached where each known injured party is awarded a one-time payment. Briefly describe two disadvantages to claimants and two advantages to insurers as a result of this settlement.

CONTINUED ON NEXT PAGE

QUESTION 6	
TOTAL POINT VALUE: 3	**LEARNING OBJECTIVE: A2, A3**
SAMPLE ANSWERS (BY PART, AS APPLICABLE)	

Part a: 1 point

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 for each of the rating agency assessment and the application of IRIS ratio 1 and IRIS ratio 11:

Rating agency assessment

- The rating agency will start by comparing to the company's position in the industry. The rating agency will question why the company only recognized 10% of the exposure compared to the other companies in the industry. The results of those ratios will help the rating agency determine whether the company should get a better rating compared to those in the industry.
- The rating agency would investigate this company thoroughly as it appears they may be potentially hiding exposure since they are only reporting 10% of the exposure, whereas other similar companies are reporting more. The lack of integrity and hiding data may come out in the interactive rating session and the company may be put on watch or have their financial rating downgraded.
- The rating agency may review the policy forms to see if there was exclusion for this type of loss which would justify the low exposure. Also interview management and see if they were familiar with the exposure. If they avoided the losses, could result in the same rating or even an upgrade. [Note while upgrade wasn't the intended answer, it was accepted if the logic was reasonable and how the rating agency made the assessment was provided.]

Application of IRIS ratios

- IRIS Ratio 1: GWP to PHS: to assess the adequacy of surplus and if there is any unusual trend of premium growth (if surplus is adequate to support the premium)
- IRIS Ratio 1 (GWP/PHS) should be reviewed. Should be lower GWP/PHS given the long tailed nature of this line of business.
- IRIS Ratio 1 (GWP/Surplus) to check if insurer is increasing its writings to pay for future losses
- IRIS Ratio 11 (One Year Adverse Reserve Development / Prior PHS) to make sure adverse development from the toxic fumes does not negatively impact surplus by a lot.
- IRIS Ratio 11: 1 Year Loss Development to PHS: If there is adverse development, company may have understated reserves in order to increase surplus. The mass tort claims could cause insolvency
- IRIS Ratio 11 (One Year Reserve development to Prior PHS) can be helpful to see whether this exposure has been appropriately reserved for. May not be if continually seeing development.

Part b: 1 point

The following provide examples of thorough responses having the necessary components to demonstrate knowledge of the topic and obtain full credit; any two of the following were accepted:

- The credit risk charge in the RBC formula will be increased with the reinsurer's downgrade
- They may have to increase the provision for reinsurance
- The reinsurer may lose creditors/investors and could go insolvent. As a result, the cedant

may not be reimbursed for losses.

- This increases the credit risk for the reinsured
- The reinsured may need to explain the reason for having low quality reinsurance in the notes to the financial statements
- Reinsureds may need to increase their reinsurance provision on Schedule F
- When the appointed actuary examines reinsurance collectability, it may result in a 'deficient' opinion.
- Reinsured may have to increase reserve, decreasing surplus, which will cause rates to increase
- Primary insurer may need to buy more reinsurance elsewhere, which could increase cost
- Policy holders of the cedant may want to do business elsewhere because the reinsurer is not strong or financial insolvent
- The reinsured may need to get more collateral in order to receive the same credit for reinsurance
- Reinsureds may have to post additional letters of credit which is costly to the reinsured and maybe difficult to obtain after the other reinsurer was downgraded

Part c: 1 point

The following provide examples of thorough responses having the necessary components to demonstrate knowledge of the topic and obtain full credit; any two of the following were accepted for each of the disadvantages to claimants and advantages to insurers:

Disadvantage for claimants:

- Seriously injured claimants may not be a fair settlement because it is based upon a class action suit
- Class-action suits and settlements have higher overhead and attorney expenses, so claimants may only get some percentage of the total award. A large portion goes towards expenses
- The long latency of the illness may result in those getting sick later and being unable to receive payment if the funds are exhausted
- Those who may not discover their injury until later may not receive any payments
- A one-time payment may not adequately reimburse injured parties with ongoing medical treatments
- A lump sum payment will decrease in value due to no adjustments for COLA or medical inflation
- Claimants will have to give up their right to sue even if they thought they deserved a larger settlement
- There maybe illegitimate claimants who receive settlement but are not terminally ill, which lowers the average amount paid
- Payment may not differentiate between degrees of injury
- No punitive damages will be awarded
- Some injured parties may not have the financial knowledge to handle a large lump sum payment
- If all the payments occur at one time, it has the potential to cause insolvency for weakly capitalized insurers, which may hinder recovery

Advantage for insurers:

- Predictability of financial results going forward

- May not get bad publicity going forward since they settled under a national settlement, assuming this sort of case would yield negative national headlines
- Reduces the costs associated with claim defense (DCE/LAE)
- The matter is closed and financial uncertainty with respect to losses is eliminated
- The risk for adverse development on these losses is eliminated
- Eliminates need to worry about future legislation with regards to this exposure
- Can disclose on SAO that will be little to no concern of future adverse development of this mass tort. Yields more credibility to actuarial opinion.
- Some injuries unknown at the time and will not get paid, which reduces the damages
- All the insurance companies are involved, so no single insurer's reputation is damaged more than the others. They are all in the same boat.
- No more expenses to monitor these claims
- Cannot be hurt by unexpected inflation or higher cost of care
- No need to keep large reserves
- Insurer has potential to close out claim for less than actual value
- Avoid reopened claims
- Reduce expenses in the long run because there is an administrative cost associated with processing claims
- Certainty and closures is important to management and investor's decision-making
- Insurer's will save money because they avoid punitive damages
- Claims can be closed and transferred to a reinsurer
- May mitigate future related lawsuits
- Has the potential to reduce coverage disputes with reinsurers
- Certainty of timing – so resources and investments may be planned better
- If it's a national settlement, more funds may be available to help cover the payments
- Deterministic payments are better to match cash flows
- Insurer's will have a clear idea how contracts are interpreted going forward and can adjust future contracts to their benefit
- New insureds will see settlement as a good sign of great claim support and continue to purchase insurance. Helps insurance companies move past the stigma

EXAMINER'S REPORT (BY PART, AS APPLICABLE)

Candidates were expected to:

- Describe the process used by rating agencies to monitor solvency and financial health
- Understand and apply IRIS ratios 1 and 11 to a given scenario
- Understand the impact of rating downgrades in the marketplace
- Describe impacts to claimants and insurers of a prescribed settlement on a mass tort exposure

Part a of this question was challenging for candidates, particularly the rating agency assessment. Many did not fully answer the question or provide reasonable responses. Candidates generally performed well on part b, assuming they gave an answer from the perspective of the reinsurer. Candidates generally performed well on part c.

Part a

Candidates were expected to describe the process used by rating agencies to monitor solvency, reserving practices, including methods used for estimating mass tort exposure, and other

formulaic and qualitative assessments (interactive rating, management discussions, etc.) of the company relative to its peers. Candidates were also expected to identify what IRIS ratios 1 and 11 are, and how a rating agency may use these in evaluating the health of the company in the question. Candidates generally were able to correctly identify IRIS ratios 1 and 11 and provide a reasonable explanation of their application. However, candidates generally did not do as well providing information on how a rating agency might assess this company. Some were not able to make the connection from what the rating agency might look at in this particular scenario, and the impact of that assessment. Common mistakes included: ▪ Not providing how a rating agency might assess this company for financial rating purposes (e.g., interactive rating, compare ratios with competitors, etc.) or what the rating agency assessment (downgrade) was ▪ Simply restating the information provided in the question. For example, saying "lack of recognition would cause concern" did not receive credit ▪ Only listing out what IRIS 1 and 11 ratios are with no explanation on how it ties to the financial health of the company ▪ Incorrectly identifying IRIS 1 and 11 ▪ Discussing impact of reinsurance (IRIS 1 shows ratio on a gross basis without consideration of reinsurance)
Part b
Candidates were expected to understand the relationship between a reinsurer and a reinsured, as well as the impact of a rating downgrade on the reinsured's financial health. Most candidates provided reasonable responses such as credit risk, provision for reinsurance, disruption in the marketplace, increased costs for reinsurance, etc. A common error was listing negative business consequences for the reinsurer rather than the reinsured.
Part c
Candidates were expected to describe the impacts to claimants and insurers of a prescribed settlement on a mass tort exposure. Many reasonable answers were accepted. Common errors included factually incorrect responses ("liability is now off the books"), vague responses, or misreading the question such as listing advantages for claimants or disadvantages for insurers.