11. (3 points)

a. (0.5 point)

Identify two elements shown in either the statutory Balance Sheet or Statement of Income that would help a regulator assess the credit risk that an insurance company faces.

b. (1 point)

Evaluate the effectiveness of each of the elements identified in part a. above in assessing the credit risk that an insurance company faces.

c. (0.5 point)

Identify the name of two Notes to Financial Statements that would help a regulator assess the credit risk that an insurance company faces.

d. (1 point)

Evaluate the effectiveness of each of the Notes identified in part c. above in enabling a regulator to assess the credit risk that an insurance company faces.

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QUESTION 11	
TOTAL POINT VALUE: 3	**LEARNING OBJECTIVE: C1**
SAMPLE ANSWERS (BY PART, AS APPLICABLE)	
Part a: 0.5 point	
The following provide examples of responses having the necessary components to demonstrate knowledge of the topic and obtain full credit; any two of the following were accepted: • Provision for reinsurance (change in the provision) • Uncollected premiums and agents' balances in the course of collection • Deferred premiums, agents balances and installments booked but deferred and not yet due • Reinsurance recoverable on paid loss • Bonds (capital allocation based on equities in the balance sheet) • Uncollectible reinsurance written off • Agents balances written off • Investment income due and accrued • Recoverable from parent, subsidiaries and affiliates • Funds held by or deposited with reinsured companies • Funds held by companies under reinsurance treaties	
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. Only one response was required for each of the two items identified in part a. • **Provision for reinsurance:** Takes into account whether a reinsurer is authorized, unauthorized and slow paying, so it arbitrarily segments the provision based on reinsurer characteristics. It also takes into account whether reinsurer has posted collateral. However; the provision is strictly formulaic. It also doesn't take into account reinsurer strength. Overall, it does an adequate job at assessing credit risk. • **Uncollected premiums and agents' balances in the course of collection:** Somewhat effective as balances over 90 days due are non-admitted. However some balanced less than 90 days overdue may not be recoverable but are not adjusted for. • **Deferred premiums, agents balances and installments booked but deferred and not yet due:** This could be a potential source of credit risk for an insurance company once these premiums are billed and if agents do not end up paying the company what they owe. This is not really an effective measure for a regulator because it does not give any details beyond the actual number shown in the balance sheet. • **Reinsurance recoverable on paid loss:** Effective to give a general idea of the extent of amount insurer relies on reinsurance; however, it doesn't show reinsurer strength so it's difficult to assess how likely the insurer is to recover it's recoverable. • **Bonds (capital allocation):** If there is a huge ratio of stocks a regulator may be concerned about the volatility of these items and the ability of the third party to pay, especially if these make up a lot of the company's assets. The regulator may need to review other parts of the annual statement to understand the bond holdings and the credit risk the company faces. • **Uncollectible reinsurance written off:** Uncollectable reinsurance allows the regulator to see how much reinsurance the company has written off during this past year. The	

regulator can use this to help determine a prospective view of potential uncollectible reinsurance in the future and can help the regulator ask specific questions to the insurer about why reinsurance was uncollectible. Overall it helps regulator access credit risk but it is a retrospective measure so it may not be indicative of future collectability.

- **Agents' balances written off:** This is a semi effective measure of credit risk. It is a retrospective look but if you expect similar conditions this can be used to estimate Agents Balances charged off next year. If there are changing conditions this may not be an appropriate measure.
- **Investment income due and accrued:** This is investment income owed to the company that has not yet been paid by a third party. This is part of the RBC charge for credit risk and will allow a regulator to effectively assess how much money the insurer could lose if the third party goes insolvent.
- **Recoverable from parent, subsidiaries and affiliates:** This is an effective measure of credit risk. Receivables over 90 days past due are a non-admitted asset and are unlikely to be collected once they are that many days past due.
- **Funds held by or deposited with reinsured companies:** A company's exposure to credit risk is increased if their assets are being held by another party if that party goes bankrupt and cannot return the funds. This is not very effective for a regulator because they have no information on the company's financial strength.
- **Funds held by companies under reinsurance treaties:** If a company is holding collateral this will reduce their exposure to credit risk. It reduces unsecured reinsurance recoverable and also reduces the provision for reinsurance. This will allow the regulator to effectively assess credit risk.

Part c: 0.5 point

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

- Notes to Financial Statements, Reinsurance (23), Sections A, B and D
- Notes to Financial Statements, Structured settlements (27)
- Notes to Financial Statements, High Deductible (31)
- Notes to Financial Statements, Subsequent Events

Part d: 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, as long as they corresponded to the answer provided in part c.:

- Notes to Financial Statements on reinsurance "provides information on specific liabilities for which the credit risk may be heightened." It allows the users to assess the impact of individual entities that could pose significant credit risk to the insurance company. It does not, however, addresses reinsurance credit risks other than those related to unsecured recoverables, recoverables in dispute and recoverables that have been deemed uncollectible, which are partially quantified in provision for reinsurance.

- Notes to Financial Statements on structured settlements "disclose the total amount of structured settlement payments for which an insurer could be held liable. Furthermore, if the amount of these remaining payment from a single life insurance company exceeds 1%

of surplus, specific disclosure of the amount and the company from which the structured settlement was purchased is required." This note effectively addresses "a potential … credit risk that is not reflected on the balance sheet." It is effective in assessing the credit risk of structured settlements because it allows the users to conduct further review on the financial condition of the individual entities that provided structured settlement.

- For unpaid claims, the portion of the unpaid amount within the deductible is not included within the insurance company's booked loss reserve in the Annual Statement. The treatment for both paid and unpaid deductible losses creates a credit risk for the insurer due to the possibility that the insured will not reimburse them for the deductible portion of the loss." Notes to Financial Statements on high deductible addresses another potential credit risk that is not reflected on the balance sheet. It is effective in assessing the credit risk of LDD policies because it helps the users understand the potential impact of this credit risk relative to the total unpaid claims and to the company's surplus.

- Subsequent events: If this note discloses a large cat event that has occurred after the date of the financial statements, this could pose a credit risk to the insurer because of the large recoverable that could be due from the reinsurer. This is only mildly effective for a regulator to assess credit risk because they only know that a significant event occurred but not the amount of losses covered by the reinsurer.

EXAMINER'S REPORT (BY PART, AS APPLICABLE)

- Generally candidates scored better on parts a. and b. versus parts c. and d.
- There are many potential causes of credit risk for an insurance company and overall candidates did a good job describing how each of the items they listed opened the company up to credit risk. A common theme where some candidates missed points was that they fell short of adequately explaining how a regulator could either effectively or ineffectively use the balance sheet elements, income statement elements or Notes to Financial statements to determine credit risk for the insurance company.

Part a

Overall candidates scored well on this part. Common errors were listing items not actually included in the balance sheet or income statement.

Part b

There are many potential causes of credit risk for an insurance company and overall candidates did a good job describing how each of the items they listed opened the company up to credit risk. A common theme where some candidates missed points was that they fell short of adequately explaining how a regulator could either effectively or ineffectively use the balance sheet elements or income statement elements to determine credit risk for the insurance company.

Part c

A candidate who simply listed two items from the Notes to Financial Statements that related to credit risk was given full credit. Candidates were expected to know and understand Notes to Financial Statements and how these pertained to the health of an insurance entity. A common error was listing a note in the financial statements that was not directly related to credit risk. There were less candidates who scored full credit on this part compared to part a.

Part d

There are many potential causes of credit risk for an insurance company and overall candidates did a good job describing how each of the items they listed opened the company up to credit risk. A common theme where some candidates missed points was that they fell short of adequately explaining how a regulator could either effectively or ineffectively use the Notes to Financial Statements to determine credit risk for the insurance company.