16. (4.25 points)

Given the following information for a monoline workers' compensation insurance company (all figures in following two tables are in thousands of dollars):

Calendar Year	2014	2013
Earned Premium	550,000	500,000
Other Underwriting Expenses	110,000	90,000
Investment Income	55,000	65,000
Premium Deficiency Reserve	37,000	0

Incurred Loss & LAE		
Years in Which Losses Were Incurred	As of December 31, 2014	As of December 31, 2013
Prior	2,047,000	1,890,000
2013	353,000	265,000
2014	287,000	-
Total	2,687,000	2,155,000

- A tabular discount of 3%, in conjunction with a defined set of U.S. Life tables, is used to book total permanent loss reserves.
- The company offers large deductible options. Deductible recoverables as of December 31, 2014 are $800,000 on paid losses and $1,200,000 on unpaid losses.
- A large factory explosion occurred on January 15, 2015. Initial estimates of total insured loss from that event is $50 million.
- The company does not have any assumed or ceded reinsurance agreements.
- The accounting date of the financial statements is December 31, 2014 and statements are issued on March 1.

a. (1.25 points)

Identify the names of the five Notes to Financial Statements that would specifically reference the information provided above and appear in the company's 2014 Notes to Financial Statements.

b. (1.5 points)

For three of the Notes identified in part a. above, provide any numeric values and descriptions that should be included within the Note.

c. (1.5 points)

For three of the Notes identified in part a. above, explain how each could assist a user of the financial statements in the evaluation of the company's financial health.

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QUESTION 16	
TOTAL POINT VALUE: 4.25	LEARNING OBJECTIVE: C1
SAMPLE ANSWERS	
Part a: 1.25 points	
Any five of the following: • Changes in Incurred Loss and LAE • Discounting • Premium Deficiency Reserve • High Deductibles • Subsequent Events • Reinsurance Assumed/Ceded • Summary of Significant Accounting Policy	
Part b: 1.5 points	
• Change in Incurred Loss ▪ (2,047,000+353,000)-(1,860,000+265,000) = 245,000;What line of business was cause ▪ Changes in Losses Note would say losses incurred on prior years are 245K = 2687-287-2155 and what caused this • Discounting ▪ Include discount of 3% and where it was derived (i.e. US life table) ▪ Tabular discount of 3%; assumption and basis • Premium Deficiency Reserve ▪ 37,000; was investment income considered ▪ 0; this assumes the figure in the table is gross of investment income • High Deductible ▪ Company needs to disclose reserve credit of $1.2M and the billed but uncollected amount of $800K ▪ Amount of recoverables on high deductible policies: 800+1200=$2M • Subsequent Event ▪ $50 million loss occurred on 1/15/2015. This event is a Type 2 (non-recognized) event, but needs to be reported because it will be material in future reserves ▪ On Jan 15 a new loss of $50M occurred. This is a type 2 material subsequent event ▪ Disclose type 2 unrecognized subsequent event occurred that will have a material impact ▪ Since this is a non-recognized subsequent event that would have a material impact disclose large factory explosion • Reinsurance Assumed/Ceded ▪ State there is no assumed or ceded reinsurance	
Part c: 1.5 points	
• Change in Incurred Loss ▪ Can help users identify whether there are significant adverse development. If adverse development consistently occurs, may question under-reserving ▪ What caused this development to assess whether material adverse risk still remains and determine whether reserves are reasonable ▪ Shows how company's reserves are developing (if high adverse development,	

could hurt surplus, must investigate cause further) just reserve strengthening? Or deficient reserves?

- Discounting
  - Different companies discount differently so this helps make Financial statements more consistently comparable
  - Helps user understand stated basis of reserves and assumptions used in calculation of discount. Different companies use different methods to determine reserves
  - Know the discounting method and amount of this insurer; user can compare different company's reserves without misleading
- Premium Deficiency Reserve
  - If no note, users may not know that deficiency exists as it is grouped with UEPR, May indicate unprofitable business
  - Can assist if non-zero by pointing to lines that have rate adequacy issues; PDR of zero does not necessarily mean that rates are adequate
  - Premium Deficiency note would enable the user to detect that rates have not been adequate. The PDR could be hidden in the UEPR and the only way a user would know is by looking at the Notes section
  - If the premium deficiency is accounted for by modifying the UEPR in the annual statement, this note is the only way user would know if deficiency. Could lead user to believe that rates are inadequate
- High Deductibles
  - Help users to estimate the credit risks associated with large deductible recoveries. If there's a major impact on company's surplus
  - Large deductible policies help user assess the credit risk that insurer is exposed to. User can take the fact that these recoverables may not be recovered into account when evaluating the company's financial health
  - If company has significant amount of recoverables under high ded policies would want to assess credit risk that might reduce financial strength
- Subsequent Event
  - Provide caveat that though Annual Statement is reflective of 2014 results there is an outstanding situation the co is exposed to. Gives regulators sense that financial condition may be weaker than implied by '14 statement
  - User would not know impact if not disclosed; amount 50M is material to the F/S and may cause insolvency
  - The subsequent event note informs us of the company's exposure to events not considered in the annual statement. The 50M loss will likely have a significant impact on surplus leaving the company in financial difficulty
  - User can see if subsequent events have caused a material change to the insurer's health after the evaluation date of the financial statement
  - Since the insured loss was $50M this event has a material impact on the financial health of the company, which the user would not be able to ascertain without the note (not included in financials as non-recognized)
- Reinsurance Assumed/Ceded
  - Since no reinsurance user will be notified that company may be at risk for

insolvency with large losses ▪ The note on reinsurance would simply indicate that the company is not reinsured and this might raise concerns to the user because WC insurance is usually written without claim limits and has a rather wide probability distribution and long-tail exposure ▪ Important to know no reinsurance because exposed to upper limit on all losses, particularly important as WC medical could skyrocket ▪ Reinsurance is very critical to protect the policyholder. Reinsurance provides cat protection and stabilizes income. Regulator and policyholders will be very concerned of this as policyholders will not get the full amount of loss in the event of insurer's insolvency ▪ Significant Accounting Policies – no candidate used this Note for part c
EXAMINER'S REPORT
Part a
The candidate was expected to be able to review the information given and identify five notes to the Financial Statement that would specifically reference that information. The candidate did not need to provide exact names of these Notes as long as they addressed the correct concepts. Common errors included retroactive reinsurance, unearned premium reserves, catastrophes, investments, and notes to other sections in the annual statement (sch. P, sch. F, page 14, etc.).
Part b
The candidate was expected to choose three notes from part a and provide any values and descriptions that should be disclosed in that note. This question was straightforward and the majority of the values required no calculations. Common errors included: ▪ Miscalculating the change in incurred losses by including the current year ▪ Providing the premium deficiency reserve without a comment on investment income ▪ Failing to acknowledge the subsequent event was not included in the annual statement ▪ Mentioning only one of the two values needed for high deductible ▪ Providing numerical values without including the description
Part c
The candidate was expected to explain how three notes could assist a user in evaluating the financial health of the company. This part of the question was the most challenging as the candidate had to go beyond the information given in the question to assess the usefulness of the information. Many candidates identified the risk that the note would illustrate; however, few provided the details that explained how this company's health was impacted by the risk. Additionally, many candidates listed general risks that weren't relevant to the particular company, such as reinsurance collectability risk when the company had no reinsurance, or non-tabular discounts when the company only disclosed tabular discounts.