

EXAM 6 – UNITED STATES, SPRING 2016

3. (3.75 points)

a. (1.5 points)

Identify and briefly describe three reasons for regulatory failure.

b. (1.5 points)

Identify and briefly describe three checks and balances in the current U.S. insurance regulatory system.

c. (0.75 point)

Briefly describe how each item identified in part b. above can successfully address one of the issues noted in part a. above.

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SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 3	
TOTAL POINT VALUE: 3.75	LEARNING OBJECTIVE: A-2, A-4
SAMPLE ANSWERS	
Part a: 1.5 points	
<p>Regulatory Fallibility – Regulators are humans. Humans make errors.</p> <p>Regulatory Fallibility – Regulators make errors since they are human.</p> <p>Regulatory Fallibility – Since regulators are human, they can be prone to errors in their assessments.</p> <p>Regulatory Forbearance – Regulators may be reluctant to take action against a potentially troubled firm because the consequences can be severe.</p> <p>Regulatory Forbearance – Failure of regulators to take prompt and stringent action when faced with a troubled insurer.</p> <p>Regulatory Forbearance – Regulators can be slow to react in taking action since if the firm fails, jobs may be lost, policyholders impacted, creditors lose, etc.</p> <p>Regulatory Forbearance – Regulators may feel pressure not to act out of fear of jobs being lost and hurting the economy.</p> <p>Regulatory Capture – Regulators over time may adopt the mindset of the entities they regulate.</p> <p>Regulatory Capture – Regulators can lose a sense of balance, enacting regulations overly biased toward the industry.</p> <p>Regulatory Capture – Regulators having the tendency to taking sides with special interest groups.</p> <p>Regulatory Capture – Regulators may not be working in the best interest of those they regulate because of lobbying or pressure from those they regulate.</p>	
Part b: 1.5 points	
<p>Duplication – multiple states oversee each insurer that does multi-state business. While one regulator may miss or ignore signs of a troubled company, it is unlikely that all regulators will miss the signs.</p> <p>Duplication of effort – Every state DOI that a company does business in is reviewing the insured so it is more likely that at least one of them will catch any issues.</p> <p>Duplication – There are many different people looking at a company's business and with more duplicate work, they will find if an insurer is in trouble.</p> <p>Peer Review – U.S. regulation features multistate oversight and peer review systems like the ones coordinated by the NAIC. When peer reviewing one another's work, they are more likely to catch errors and issues.</p> <p>Peer Pressure – When one state detects a weakness in regulation by a domestic regulator's analysis, they can question that state, encourage changes, and in worst case, bring pressure to bear on the regulator to act.</p> <p>Peer Pressure – Any state that an insurer does business in can take action on an insurer even if another state does not which will apply pressure for other states to do the same.</p>	

SAMPLE ANSWERS AND EXAMINER'S REPORT

Diversity of Perspective – There are many perspectives among state regulators, from those strongly concerned about the costs of overregulation to those primarily concerned with adverse consumer outcomes from deregulation. Different vantage points will avoid far out policies.

Diversity of Thought – The need for consensus and compromise among such divergent viewpoints tends to result in centrist solutions that avoid extremes.

Diversity of Perspective – Different regulators have different political backgrounds and outside influences, the diversity keeps regulation from going too extreme in either direction.

Market Discipline – With regulation by the states, there needs to be discipline in the market since outside funding can be hard to get.

Moral Hazard – Since insurance regulation is primarily state based, access to federal bailout funds is limited and difficult to obtain.

Part c: 0.75 points

Duplication – With more sets of eyes and states duplicating work, they are more likely to catch human errors, thus avoiding Fallibility.

Peer Review – When you have peer review systems like the ones coordinated by the NAIC, they are going to catch more errors and reduce fallibility.

Peer Pressure – This can combat forbearance, when a state identifies an issue that another state overlooked or ignored, they can pressure them to take action.

Peer Pressure – One state can pressure another state into not siding with special interest groups (regulatory capture) and have them do the right thing.

Diversity of Perspective – diversity of perspectives will reduce capture because one regulator may not be under the influence of the same or any industry group as another regulator and can see the issues clearly.

Diversity of Thought – different thoughts or perspectives may lead to regulators making different decisions on whether or not to take action on an insurer. This will fight forbearance with regulators being less slow to react and take charge.

Market Discipline – This imposes a certain discipline on both the markets and the regulators and could work against capture and siding with interest groups.

Moral Hazard – Without the availability of bailout funds, regulators are more likely to take action and avoid forbearance.

EXAMINER'S REPORT

This question tested candidates' knowledge of the failures of a regulatory system and the checks and balances that are in place to make sure those failures don't happen. The question further tests a candidates' knowledge to apply the checks and balances to which failures they can best prevent.

SAMPLE ANSWERS AND EXAMINER'S REPORT

Part a
Most candidates were able to list the types of regulatory failure. Further, they were able to briefly describe what those failures were. Common errors included simply forgetting one of the types of failure or forgetting what the definition of one of the failures was. Another common error was that the candidate would get the types of failure correct, but would mix up the definitions of fallibility, forbearance or capture.
Part b
<p>This question was testing the checks and balances in place to help against regulatory failure. Most candidates were able to identify the checks and balances. Where there was struggle with this part, it was with describing them. It was common to have correct identification, but have wrong descriptions or descriptions that did not offer anything beyond the identification. We note that the main definitional problem was with peer review. If the candidate successfully identified diversity of perspectives or duplication, typically the candidate provided the correct definition. Examples of wording that did not get receive credit is as follows:</p> <ul style="list-style-type: none">• Peer Review: "Checking others work" – did not give provide enough information to support what was being reviewed• Peer Review: "Multiple states work together" – this is an example where the item was listed with no description at all; the most common situation.
Part c
<p>The question required application of the checks and balances to which types of failure they can prevent. Candidates had the most difficulty with this part. A common error was that a candidate would elaborate further on their answer in part B, but not draw any connection to part a. or a type of regulatory error. Examples include:</p> <ul style="list-style-type: none">• "Peer review can decrease forbearance"• "Duplication will catch regulatory capture" – both don't offer anything of significance to demonstrate knowledge of how one can prevent the other• "Monitoring and early detection programs give regulators advanced warning" – may be getting at fallibility or forbearance, but not sure which/how.• "Other states can review annual statements of other insurance companies in different states if they believe in difficulty" – this is a further definition of duplication, but doesn't have a link to a key. <p>It was also common for a candidate to say that one check in the system matched with one regulatory failure, but with no brief additional explanation of how or why that is true.</p>