

EXAM 6 – UNITED STATES, SPRING 2016

13. (2 points)

A regulation has been proposed that would require insurance companies to hold total IBNR reserves using a schedule of IBNR reserves per open claim based on the age of a cohort of claims:

Proposed IBNR Reserve Schedule	
Age of Cohort of Claims	Required IBNR Reserves (per open claim)
12 months	\$12,000
24 months	\$10,000
36 months	\$8,000
48 months	\$6,000
60 months	\$4,000

Given the following for an insurance company:

	2014 Schedule P (Amounts as of December 31, 2014)				
	Part 2	Part 3	Part 4	Part 5, Section 1	Part 5, Section 2
Accident Year	Incurred Net Losses and Defense and Cost Containment Expenses Reported (000)	Cumulative Paid Net Losses and Defense and Cost Containment Expenses Reported (000)	Bulk and IBNR Reserves on Net Losses and Defense and Cost Containment Expenses Reported (000)	Cumulative Number of Claims Closed with Loss Payment Direct and Assumed at Year-End	Number of Claims Outstanding Direct and Assumed at Year-End
2010	\$61,000	\$32,000	\$4,000	3,800	400
2011	\$80,000	\$54,000	\$12,000	4,000	1,400
2012	\$107,000	\$80,000	\$20,000	10,000	300
2013	\$126,000	\$72,000	\$28,000	7,700	1,800
2014	\$109,000	\$48,000	\$34,000	7,000	2,500

- The number of IBNR claim counts for accident year 2011 is assumed to be zero.

a. (1 point)

Calculate the company's average unpaid claim severity for accident year 2011 as of December 31, 2014, assuming the regulation was in effect at year-end 2014.

b. (1 point)

Describe two potential disadvantages of implementing this reform to users of an insurer's financial statements.

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SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 13	
TOTAL POINT VALUE: 2	LEARNING OBJECTIVE: C1
SAMPLE ANSWERS	
Part a: 1 point	
<p>Unpaid Case Reserve Estimate for AY 2011 = (80M – 54M -12M) = 14M Number of claims outstanding = 1,400 Average Unpaid Claim Estimate for AY 2011 = 14M / 1,400 = 10K Required IBNR @48 months for AY 2011 (post regulation) = 6K per open claim Average Unpaid Claim Severity for AY 2011 (post regulation) = 10K + 6K = <u>16K</u></p> <p>OR</p> <p>Unpaid Case Reserve Estimate for AY 2011 = (80M – 54M -12M) = 14M Required IBNR for AY 2011 (post regulation)= 6K * 1,400 = 8.4M Unpaid Claim Estimate for AY 2011 (post regulation)= 14M + 8.4M = 22.4M Average Unpaid Claim Severity for AY 2011(post regulation) = 22.4M / 1,400 = <u>16K</u></p>	
Part b: 1 point	
<ul style="list-style-type: none"> • Significant change to IBNR reserving practices will likely change overall reserve figures in comparison to prior financial statements. This damages consistency and makes comparison to prior statements difficult. • Users would lose insight into the companies own belief about IBNR reserves per open claim which are likely to be different from industry and legislation since the regulations are “one size fits all”. • The year over year change make the results difficult to compare and mislead users to believe that they have been an improvement or deterioration of reserves which is only driven by the regulation change and not actual experience. • The regulation ignores the risks inherent in each line of business so reserves for long tailed lines would potentially be under-reserved and short tailed lines would potentially be over-reserved. This would be misleading to investors and rating agencies (users of the financial statements). • The regulation ignores the unique characteristics of each claim. Claims that remain open longer are likely more complex and volatile, potentially needing more IBNR per open claim. Quick settling claims are more certain and need less IBNR. Depending on the mix of business of the company, the schedule could be inappropriate which could lead to solvency concerns by regulators. 	
EXAMINER'S REPORT	
<p>The question challenged candidates to think creatively about how a regulation change would impact the end users of the financial statements. While this tested core understanding of Schedule P, the question required candidates to think critically and show a broader understanding of the financial statements.</p>	

SAMPLE ANSWERS AND EXAMINER'S REPORT

Part a
<ul style="list-style-type: none">• This question tested basic knowledge on Schedule P Parts 2, 3, and 4.• Candidates were expected to know how to manipulate the values in the financial statements to calculate meaningful statistics for a given company. It was important to know that IBNR is included in Part 3 of Schedule P.• Common mistakes include:<ul style="list-style-type: none">○ The most common mistake was for candidates to double count IBNR.○ While all 5 years were provided, the question was only asking about 2011 statistics. Some candidates completed calculations on all 5 years or on an incorrect year.○ In assessing the impact of the reform, some candidates restated the open claim counts instead of restating the IBNR.
Part b
<ul style="list-style-type: none">• The candidate was expected to understand the impact of the prescribed IBNR schedule and explain how it negatively impacted the users of the financial statements.• Common mistakes include:<ul style="list-style-type: none">○ Not providing enough information in support of their answer, particularly not relating disadvantages back to the users of the financial statements.○ Including disadvantages of implementing the reform (cost to implement or potential for mistakes to be made) but not addressing a <u>user</u> of the financial statements○ Referencing impacts to changes in paid and/or case reserve which would not be impacted by the proposed reform.○ Referencing lack of knowledge of true carried reserves. While the schedule may distort the company's best estimate of reserves, the proposed reform would be the company's <u>actual</u> carried IBNR reserves.