3. (3.5 points)

   a. (1 point)

      Briefly describe four possible causes of insurer insolvency.

   b. (0.5 point)

      Describe how the bankruptcy process for insurers differs from the bankruptcy process for companies in other industries.

   c. (1 point)

      Describe one argument in favor of and one argument against more stringent solvency regulations for the insurance industry.

   d. (1 point)

      Describe the two main steps of the regulatory intervention process for an insurer that may be at risk of becoming insolvent.

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**SAMPLE ANSWERS AND EXAMINER'S REPORT**

| **QUESTION 3** | |
|---|---|
| **TOTAL POINT VALUE: 3.5** | **LEARNING OBJECTIVE: A2** |
| **SAMPLE ANSWERS** | |
| **Part a:** 1 point | |
| Any four of the following:<br>• Uncollectible Reinsurance or Reinsurer Bankruptcy<br>• Catastrophic Loss<br>• Inadequate Rates or Poor Underwriting or Lack of data<br>• Rapid Premium Growth<br>• Inadequate reserves, Significant adverse development<br>• Fraud<br>• Lax Control over Managing general agents<br>• Entering into a new market, New territory, Cyber Liability<br>• Investment Practices, Speculative Investments, Risky Investments<br>• Asbestos Losses, Court rulings | |
| **Part b:** 0.5 point | |
| • Non-insurance goes to court directly. For insurance, receiver is assigned for the liquidation. Before liquidation, regulator can restrict business of financially troubled insurers or take corrective actions/control of companies before it goes insolvent. Insurance is also protected by guarantee fund.<br>• Bankruptcy is handled at state level instead of at federal level. There is a guaranty fund to still pay for claims even though there are restrictions.<br>• Before bankruptcy, the commissioner comes in and tries to help the at-risk company. This is called a receivership. The company can then either be rehabilitated or liquidated. If liquidated, policyholders are covered by guaranty funds which do not exist in other industries.<br>• Not just creditors demanding payment but also policyholder. State guaranty funds are available but less likely to receive federal bailout money due to state regulations of insurance. Other industries just have creditors, no guaranty funds, but yes to fed $.<br>• Bankruptcy process for insurers is handled at state level with the state DOI's/commissioner overseeing liquidation and insolvency with the use of guaranty funds. Other industries have bankruptcy handled at federal level and have possible access to federal funds.<br>• Insurance is unique since it is regulated by the state not the federal and the state holds a guarantee fund to repay customers and claimants | |
| **Part c:** 1 point | |
| • Against – insurer insolvencies are rare compared to the non-insurance industry and in the event of insolvencies, guaranty funds have done a good job of compensating policyholders. For – insurance, unlike most other products, is a promise to pay that the public depends on. Insolvencies to insurers are far more threatening than bankruptcies of non-insurance companies. | |

- For: In some cases, insurance is a compulsory purchase and the main objective is to protect the policyholders. A stringent solvency regulations would protect them the most. Against: Because regulation is at the state level, failing regulation is picked up by peer review of other state regulators. The current system has been proven to be doing a good job.
- In favor – In order to keep rates fair and protect policyholders, there should be more stringent solvency regulation for the interest of the public, so companies don't go insolvent and can't pay claims. Against- insurance industry has done a good job in monitoring preventing insolvency as is. Also, back stops in place where they do occur, i.e. guaranty funds.
- Favor – costs of insolvencies either distort the market (guaranty fund assessments) or harm consumers, so more should be done to prevent insolvencies. Against- system is currently working reasonably well to prevent insolvencies
- More regulations will add more levels of Solvency protection by increasing duplication and checks and balances (Advantage.) More Stringent solvency regulations might cost too much and shift some of that cost to the policyholders. (Disadvantage)
- For: To better protect consumers, the regulators need to make sure the insurance companies have enough surplus to pay for the claims. More stringent solvency regulation is better for this. Against: More stringent solvency regulations can hinder competition which potentially will harm availability of insurance products. This can also cause compliance cost to increase.
- In Favor: the main purpose for solvency regulation is to protect policyholders. Requiring more stringent solvency standards would better ensure this. Against: the more stringent the standards, the harder it will be for insurers to meet the standards. This could cause insurers to pull out of markets or increase rates, causing an increase in the residual market or unaffordable and unavailable coverage.

**Part d:** 1 point

- Fact Finding – using IRIS /RBC/Annuals statements to grade insurers and highlight those that might be at risk of insolvency.
  Company Intervention - If it's required the following steps may be needed: Mandatory insurer action, Administrative action, rehabilitation, liquidation.

**EXAMINER'S REPORT**

The candidates were expected to know or be able to describe current programs used to monitor solvency including insolvency

Candidates performed well with part a, but for the rest of the question not as well. The candidates seemed to have trouble interpreting what the question was asking.

**Part a**

The candidates were expected to list 4 items out of a possible 8 choices, 6 directly from the Porter reading.

Common mistakes included:

- Bad management – not specific enough, all of the reasons given are bad management.
- Inadequate reinsurance – no credit – need to say uncollectible reinsurance unless mention that reinsurance is inadequate in case of large catastrophic loss.
- Discussing pricing or rates 3 times with different complaints about the rates.
- Heavy concentration in one area or line of business (such as homeowners)
- High expense ratio
- Regulatory fallibility (From the Vaughan paper on "The Economic Crisis and Lessons from (and for) U.S. Insurance Regulation.)
- Adverse selection – not a direct cause,

**Part b**

The candidates were expected to compare the bankruptcy process for insurers and other industries. The candidates were expected to know federal bankruptcy courts were not used for insurance companies, if a state court judges has determined that an insurer is insolvent, then state law governs the insurer's orderly liquidation and payment of claim. Insurance guaranty funds, which pay claims made against insolvent insurers, are another unusual aspect of the insurance industry.

Common mistakes included:

- Describing the insolvency process for insurers without comparing to other industries
- Describing state commissioner for other industries that do not have commissioners

**Part c**

The candidates were expected to provide an argument for and against a potential change to the solvency regulatory environment.

A number of the candidates described the argument for more stringent solvency regulation than is currently in place and other candidates described the current situation and why less stringent solvency regulation is better. Credit was given for both viewpoints.

The most common errors were:

- Insurers have done better than other industries, does not need more regulation.
- Discussed need for rate regulation or affordability and availability not solvency regulation.
- Candidates just say more regulation or less regulation is better without a reason.
- Companies would have to keep more capital in surplus to meet solvency requirements, so there is less opportunity for them to invest the money to get better returns. (It would seem that more capital implies more money to invest.)

| **Part d** |
|---|
| The candidates were expected to reply with Step 1 – Fact finding where the regulator tries to develop a clear picture of the insurer's balance sheet through a fact-finding process either at an insurer's office and/or through written reports. Step 2 is implementation of regulatory actions which includes mandatory corrective action, or administrative supervision or placing the insurer in receivership for rehabilitation or ultimate liquidation.<br><br>Common mistakes included:<br>• Describing current programs used to monitor solvency with mandatory corrective action as the first step and administrative supervision, receivership, and/or liquidations as the next.<br>• Discussing only corrective actions but not administrative supervision.<br>• Describing only minor actions not major actions, should at least mention placing insurer in receivership.<br>• Explaining step 1 (fact finding) twice<br>• Writing "fact Finding" and "Company Intervention" without further detail. |