5. (2.5 points)

   Propose a new system of rate and solvency regulation for the U.S. insurance industry, commenting specifically on the role of the federal government and the role of the states. Describe two potential advantages and two potential disadvantages of this proposed regulatory system.

CONTINUED ON NEXT PAGE

SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 5	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVES: A2, A4**
SAMPLE ANSWERS	

New system of rate and solvency regulation:

- Would put solvency regulation at the federal level and rate regulation at the state level. Federal gov't would use IRIS ratios, RBC and ORSA to determine company position. States would have ability to choose regulatory filing requirements (e.g. prior approval, file and use, use/file, no file)
- Federal regulation with no state regulation or interference. The federal government is responsible for regulation, monitoring, licensing, rate approvals, financial assessments, and ensuring insurer solvency of the insurance industry

<u>Sample Responses for Advantages of the program:</u>

- State solvency regulation: Duplication exists because multiple states regulate a given company (multi-state insurer) can reduce regulatory fallibility (human error).
- Federal solvency regulation: Reduce costs – by having uniform forms/processes/requirements, insurers can operate in multiple states much easier. This will reduce expense ratios across industry and therefore reduce prices to policyholders
- Federal solvency regulation: Makes it easier for the US to negotiate/comply with the trade agreements affecting insurance, as it eliminates potentially discriminatory treatment of foreign insurers (e.g. unauthorized reinsurance)
- State solvency regulation: Diversity of perspective – multiple views lead to more centrist (rather than extremist) solutions. Reduces regulatory capture (regulator siding with special interest group)
- Remove prior approval: removing prior approval will allow insurers to more quickly get rates to market. It allows competition to play a more active role in rate regulation which increases coverage availability and better risks segmentation
- File and use: file and use allows more flexibility in setting rates so insurers can respond more quickly to changes in the market place while still giving regulators the ability to review rates In a timely manner
- ORSA: ORSA provides a solvency approach that is more sensitive to management input, potentially allowing for more accurate and transparent solvency regulation
- Using Solvency II the insurers can better reflect its capital requirement with respect to the inherent risk of each line of business. E.g. homeowners policies capital requirement can include provision for catastrophe risks
- State rate regulation: Rates based on coastal hurricane or earthquake exposure will be regulated by regulators at the state level who better understand those risks

<u>Sample Responses for Disadvantages of the program:</u>

- Federal solvency regulation: Regulatory capture – lacking the diversity of perspective in the state regulation system, it will be easier for the single regulator at the federal level to side with one interest group or have one extreme view on insurance regulation

- Federal solvency regulation: Lack of duplication/redundancy increases the likelihood of regulatory mistakes going unnoticed, potentially allowing preventable negative outcomes (e.g. insolvencies) to occur
- Use and file: Use and file regulatory system is not as strict as a prior approval system so companies may get away with damaging practices for a time, even if those might be caught and fixed eventually
- Prior Approval: since approval takes time, insurers may not be able to respond to market changes quickly and could risk adverse selection
- IFRS: IFRS aspects would make it harder to compare and monitor because each insurer's internal model will be different so would need to develop expertise in understanding the models and how to compare companies
- State rate regulation: rate regulation by the states makes it more difficult for insurers to operate in multiple states. The different filing requirements may be too burdensome to deal with in order to expand to multiple states
- State rate regulation: may be inefficient as it requires multiple filings with multiple regulator bodies which takes a lot of time and effort
- Federal solvency regulation: open ins industry to possibility of federal bailout, which could lead to company less concerned about solvency. As they will always have notion of a bailout in back of mind

EXAMINER'S REPORT

The candidates were expected to use their knowledge of the current state and federal insurance regulation system to propose a new system of rate and solvency regulation, and provide advantages and disadvantages of the proposed system.

Candidates were generally able to adequately propose a new system of rate and solvency regulation. A range of new system ideas was allowed. A response that did not receive full credit was to suggest a system that was not plausible under basic US law, or one that did not make sense across any private business.

Common mistakes included:

- Candidates did not give details on the identified (dis)advantage – either the reason the (dis)advantage would occur, or a potential impact on the industry
- (Dis)advantages did not make sense, given the system they described.
- (Dis)advantages were contradictory – e.g. opposite effects described for the same system. Examples:
  - Describing a system under which state and federal regulators cover non-overlapping topics, then saying that duplication of effort is a disadvantage
  - Describing a system with only state or only federal regulation applies, and listing duplication of effort is a disadvantage
  - Stating that 'double review' by two regulators will help catch errors after describing a system where there is only one regulator (state or federal)

Note: The initial posting of the Examiners Report stated that "Candidates were further expected *to compare their proposed system to the existing regulatory system." This comment was included erroneously, and such a comparison was not required.*