2. (2.5 points)

   a. (1 point)

      For each of the following groups, describe why rating agencies are important:

      i. Policyholders

      ii. Property-Casualty Insurers

   b. (0.25 point)

      Briefly describe an incentive for rating agencies to invest in creating more accurate models to determine financial strength ratings.

   c. (0.5 point)

      Assume that capital standards are derived from accurate and reasonable models. From the perspective of a rating agency, briefly describe one benefit of having high capital standards, and one benefit of having low capital standards.

   d. (0.75 point)

      Briefly describe three differences between NAIC RBC requirements and rating agency capital requirements.

CONTINUED ON NEXT PAGE

QUESTION 2	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: A3**
SAMPLE ANSWERS	
Part a: 1 point	

Sample Responses for "Policyholders"

- Helps them choose financially strong insurers who can pay their claims
- Policyholders don't have sufficient knowledge to measure the true financial strength of an insurance company. The rating may help them pick strong companies to buy insurance.
- Ratings agencies provide policyholders with easy access a rating based on proprietary information about operating strategy and competitive advantages.
- Provide indication of strong insurer when shopping for insurance. Policyholder may be required to buy from high rated company for mortgage or surety or specialty lines.
- Ratings are used to determine financially strong insurers and help decide which insurer to buy from.

Sample Responses for "Property-Casualty Insurers"

- Helps them get business, especially in mortgage and surety as sometimes required A-rating or above to write business.
- Rating agencies provide considerable expertise in evaluating structure and operations and a rating agency can provide an external benchmark without requiring the intervention of a regulator.
- Producers can only place coverage with insurers with certain ratings. Having a good rating can increase sales and demonstrate financial health to regulators.
- Insurers want to purchase reinsurance from strong companies to reduce credit risk penalty and evaluating other companies is difficult to do.
- Allow insurers to know how they compare to competitors and influence the capital structure, reinsurance program, and business volume by benchmark.
- Demonstrate you are a financially strong reinsurer with a good rating and do not need to post collateral to primary company.
- Less expensive to use a rating agency than to demonstrate financial strength to investors for insurer that needs a good rating to issue debt securities or have stock publicly traded.
- Reinsurers can charge higher prices with high rating and rating agency will show rating.

Part b: 0.25 point

- Increase competitive advantage over other rating agencies, gain customers and profits.
- More trust in the models by the public increases demand for and reliance on the ratings.
- If agencies change ratings frequently they may lose credibility and improved model may stabilize ratings.
- Competition from ORSA and RBC imply rating agencies need good models.
- Accurate model helps an agency attract insurers who might be mis-rated by generic model.

- More accurate models will improve rating agency reputation

Part c: 0.5 point

Sample Responses for "benefit having high capital standards"

- Retain only high-quality clients
- Gain more trust from users of the rating
- High standard would ensure highly rated company could survive stress events
- Regulators might want companies to be rated by rating agency that has high standard so more companies will need to be rated by high standard agency
- High standard will attract insurers that want to be differentiated by high rating from strict model

Sample Responses for "benefit of having low capital standards"

- Gain more market share
- More desirability from clients

Part d: 0.75 point

Any three of the following:

- Rating agency incudes risks not in RBC such as catastrophe risk
- RBC worst case year vs. rating agency may use value at risk or expected policyholder deficit (EPD)
- RBC is a fixed formula and rating agency may use stochastic economic capital models
- RBC has one model used for all companies but rating agencies models differ so the rating agency model used for different companies may differ when a different rating agency is used for each
- RBC can cause regulatory action but rating agency does not have this power
- RBC is a transparent public formula while rating agency uses opaque proprietary formula
- RBC is the same for all lines vs. rating agency which may vary by line
- Regulator is stakeholder for RBC while stakeholder for rating agency is consumer, agent, investor
- RBC is quantitative formula while agency also uses qualitative information from interview process
- RBC based on public data; rating agency uses confidential data
- Regulator is stakeholder for RBC while stakeholder for rating agency is consumer, agent, investor (if related to conservatism of RBC and/or going concern of rating agency)
- RBC changes infrequently based on model law while rating agency can adapt and change in response to emerging issues
- RBC does not consider reserve adequacy, but rating agency does
- RBC does not discount reserves, but rating agency uses a conservative discount rate

EXAMINER'S REPORT

Candidates were expected to know the fundamental value of rating agencies with respect to what they do, how they do it, why they are needed, and how they may differ from the NAIC RBC

approach.

Part a

Candidates were expected to fully articulate the value of rating agencies to both policyholders and property-casualty insurance companies.

Common errors include:

- Providing only a brief description when the question asked for a description such as "Ratings agencies provide policyholders with easy access a rating"
- Describing the information a policyholder could obtain from a rating but not describing the resulting policyholder action (purchase decision) or benefit of having that information
- Stating that rating agencies can make sure the insurance price is fair to policyholders and the coverage will protect policyholders. Rating agencies do not monitor fair prices or adequacy of coverage.
- Discussing the use of advisory organizations that provide loss cost information for pricing purposes rather than rating agencies that provide financial strength ratings

Part b

Candidates were expected to articulate at least one reason why a rating agency would want to improve the model it uses to evaluate an insurance company's financial strength.

Common errors include:

- Failure to establish how a more accurate model would benefit the rating agency.
- Discussing how more accurate models would benefit the insurance industry instead of how they would benefit the rating agency that developed the improved model.
- Describing a benefit to the public or policyholders but not a benefit for the rating agency

Part c

Candidates were expected to use the perspective of a rating agency to identify at least one advantage to the rating agency of setting relatively high capital standards for insurance companies and one advantage of setting relatively low capital standards.

The most common error was the failure to approach this from the perspective of a rating agency and describing a benefit to the company instead.

Part d

Candidates were expected to compare and contrast, in at least three ways, NAIC RBC requirements vs. capital requirements of a rating agency.

Common errors include:

- Listing a fact about RBC without comparing it to agency capital requirements
- Providing a true statement that does not address how the capital standard differs between RBC vs. rating agency
- Describing a difference that is not related to capital requirements (fee for rating, required vs optional, percentage vs letter grade, frequency of evaluation, filing dates)