3. (2.5 points)

   a. (0.5 point)

      Briefly describe two motivations for the creation of Risk-Based Capital (RBC) requirements.

   b. (0.75 point)

      Briefly describe three attributes of RBC that make it useful to regulators.

   c. (0.5 point)

      Identify two risk categories being developed for inclusion in the RBC requirement.

   d. (0.75 point)

      An insurance company is on the verge of insolvency. Briefly describe three actions that can be taken to avoid insolvency.

CONTINUED ON NEXT PAGE

QUESTION 3	
TOTAL POINT VALUE: 2.5	LEARNING OBJECTIVE: A2

SAMPLE ANSWERS

Part a: 0.5 point

Any two of the following:

- Consistent and objective tool is needed to assist in the solvency regulation process by providing early warnings
- RBC requirements include both the formula and model law act which provides the regulator to take necessary correction actions
- To have a uniform set of rules for the insurance industry to measure main risks and capital requirements
- To create an additional tool to protect policyholders from insurers' insolvencies
- Standardized methodology to allow easier company comparisons
- Relieve burden from regulators to extensively investigate each insurer. Allows them to prioritize the troubled companies
- Way to objectively monitor financial strength relative to risk insurers have – this is a formulaic way to calculate which removes management judgment which can be manipulated
- Way to identify insurers early that are potentially financially troubled. Different action levels ensure action is paired appropriately to financial condition

Part b: 0.75 point

Any three of the following:

- It's formulaic and easy to understand
- It's consistent across companies which make it easier to compare companies and prioritize where to act
- It gives regulators the authority to step in and take over financially troubled insurers
- It's based on the actual risks faced/undertaken by each insurer (with riskier insurers having higher capital requirements) so it helps regulators determine which insurers it should spend more time on.
- The RBC model law authorizes regulators to take corrective action against an insurer or to take control of the insurer under certain conditions, so it acts as an early warning system before it's too late to rehabilitate insurers
- Data is verifiable from Annual Statement
- Calculations are simple and formula based
- Calculations are consistent industry wide which allows for better comparisons by regulators
- Flexible to capture different insurer's characteristics and financial positions
- Very strict and conservative capital requirements
- The RBC model laws allow regulators to take action like liquidation

Part c: 0.5 point

- Operational risk
- Catastrophe risk

Part d: 0.75 point

Any three of the following:

- Limit new business, since the insurer has less information about these new risks which reduces margin for error
- Exit a segment that might be unprofitable
- Buy appropriate reinsurance coverage
- Tighten underwriting guidelines to non-renew bad policies
- Suspending policyholder/stockholder dividends
- Merger or Acquisition with another company
- Regulator can require insurer to increase capital
- Regulator can require insurer to cut back on operating expenses
- Regulator can restrict new business writings of insurer until stable
- Decrease investments in risky assets
- Limit new or renewal business in unprofitable lines

EXAMINER'S REPORT

Candidates were expected to know the motivation for the creation of RBC, the attributes of RBC, components being considered for inclusion in RBC and actions to take to reduce the risk of insolvency.

Part a

Candidates were expected to know the motivation for the creation of RBC and understand the underlying issues with the historical capital requirements.

Common errors include:

- Failure to provide two unique answers
- Stating that the need for RBC was to measure solvency without mentioning anything specific to RBC such as consistency or objectivity that may be lacking in other methods of determining solvency
- Stating an aspect of RBC without describing the motivation for creating it

Part b

Candidates were expected to know attributes of RBC that make it useful for regulators.

Common errors include:

- Not providing a useful attribute from the perspective of the regulator
- Stating an aspect of RBC without describing how it is useful to the regulator (Example: "Uniform", "consistent" or "standardized" without describing how these attributes help regulators compare insurers.)
- Providing a risk component included in the RBC formula which is not considered to be an attribute of RBC
- Providing two or more answers that were too similar and considered to be duplicate answers (Example: "Transparent" and "easy to understand")

Part c
Candidates were expected to know risk categories that are currently not included in RBC and are being developed for inclusion in the RBC requirement. This topic is pulled directly out of the text. A common error was stating risk charges that are currently included in the RBC requirement
Part d
Candidates were expected to know preventive actions that can be taken to avoid insolvency. Common errors include: • Providing actions of rehabilitation, receivership, liquidation or bail out which assumes the insurance company is already insolvent • Providing actions of increasing rates, changing rate plan, or addressing income statement deficiencies. To avoid insolvency, the imbalance of assets and liabilities must be addressed quickly.