5. (2.25 points)

   a. (0.25 point)

      Briefly describe the purpose of guaranty funds.

   b. (1 point)

      Fully describe the most common process used by guaranty funds to assess insurers.

   c. (1 point)

      Evaluate the potential effectiveness of a proposal to assess each insurer a small percentage of its written premium in a state in order to pre-fund the state guaranty fund.

CONTINUED ON NEXT PAGE

QUESTION 5	
TOTAL POINT VALUE: 2.25	**LEARNING OBJECTIVES: B1, B2, B3**
SAMPLE ANSWERS	
Part a: 0.25 point	
Sample 1: The purpose of a guaranty fund is to protect policyholders (or insureds, beneficiaries, etc.) against losses that might result from the insolvency (or impairment, bankruptcy, liquidation) of an insurer that does business in the state. Sample 2: When an insurer goes insolvent, pay out claims to affected policyholders.	
Part b: 1 point	
Sample 1: Most states follow a post-solvency assessment approach, where the guaranty fund assesses the remaining solvent insurers in the state based on their written premium (or market share) divided along lines of business. Sample 2: Post-Solvency Assessment: • Regulator determines the amount of funds needed • Regulator charges assessment to remaining insurers based on market share • Assessments are capped at a % of WP and can recur for multiple years	
Part c: 1 point	
Any four of the following: Advantages: • The funds would be ready when an insolvency happens if they are prefunded (quicker relief for policyholders) • The fund can earn investment income on the assessments collected over time, lowering the amount required from insurers • The pre-funding method would guarantee the fund is funded at all times • Increase speed of claim payment when insolvency occurs • Less admin cost after insolvency • Increased protection for policyholders since a reserve can be built up • Less disruptive than large assessment after insolvency • Insurers can anticipate cost upfront and plan accordingly • State can invest the funds and earn investment income • Future insolvent insurers also contribute to the fund, which may be more fair Disadvantages: • Prefunding can incur expenses for insurers for a fund that might not even be used, which would increase costs that trickle down to policyholders through rates • Determining the actual percent of written premium would be difficult (fund may end up	

over/under-funded)

- The pre-funding amount is factored into pricing and hence more expensive for policyholders
- Insurers cannot invest the funds collected by the guarantee fund
- The small percentage of WP may not be enough when an insolvency occurs
- Difficult to estimate the appropriate percentage ahead of the time
- With the backdrop, consumers may be indifferent in choosing insurers – this may hurt the insurers with strong financial rating and underwriting
- If the assessment is based on total WP, it may be unfair since only certain LOBs are covered by Guaranty Funds
- WP is not always correlated with risk & exposure; Companies with different risk levels may be assessed the same %
- May not have insolvency for a long time so pre-funding may be inefficient
- May be a burden for insurers at the verge of insolvency; The additional financial burden could lead to more insolvencies
- The additional costs in pre-funding states may cause insurers to focus more on growing in other states and at the extreme level, stop writing business in pre-funding states
- Large (stable) insurers may be subsidizing the smaller insurers which may be more likely to go insolvent

EXAMINER'S REPORT

Candidates were expected to understand the purpose and operation of state guaranty funds and to assess the effectiveness of a pre-funding approach.

Part a

Candidates were expected to briefly describe the purpose of a guaranty fund.

The most common error was not mentioning anything about insurer insolvency.

Part b

Candidates were expected to fully describe how guaranty funds most commonly assess insurers (post-insolvency assessment).

The most common error was describing a pre-insolvency funding approach or not fully describing the process.

Part c

Candidates were expected to evaluate a pre-funding methodology (generally via a comparison to the more common post-insolvency assessment).

The most common error was not explaining/describing the rationale behind the listed advantages and disadvantages.