12. (3.75 points)

An insurance company began operating on January 1, 2013. Below is information from its 2015 Annual Statement. All figures are in millions of dollars.

	2015	**2014**	**2013**
Gross Premiums Written	1,140	520	130
Net Premiums Written	855	520	130
Gross Premiums Earned	877	367	33
Net Premiums Earned	600	367	33
Statement of Income			
Other underwriting expenses incurred	150	78	24
Net investment gain	15	13	0
Total other income	10	10	0
Dividends to policyholders	1	0	0
Federal and foreign income taxes incurred	2	5	1
Balance Sheet Lines			
Total admitted assets	870	640	390
Losses	165	120	20
Loss adjustment expenses	45	20	1
Surplus as regards policyholders	300	310	280
Gross Losses Paid	580	260	30
Net Losses Paid	435	260	30
One Year Loss Development	66	-1	
Two Year Loss Development	-1		

Underwriting and Investment Exhibit
Part 3 – Expenses

	Loss Adjustment Expenses	Other Underwriting Expenses	Investment Expenses	Total
Total Expenses Paid	50	136	95	281

<<QUESTION 12 CONTINUED ON NEXT PAGE>>

a. (1.75 points)

Calculate the insurance company's 2015 net income.

b. (1 point)

Fully describe one concern a regulator might have with the insurance company's balance sheet strength at year-end 2015 based only on the information presented above.

c. (0.5 point)

Briefly describe "Note 23. Reinsurance" in the Notes to Financial Statements, and briefly describe why the regulator might consult this note for this company.

d. (0.5 point)

Describe how Schedule F may assist the regulator in assessing the company's balance sheet strength.

CONTINUED ON NEXT PAGE

QUESTION 12	
TOTAL POINT VALUE: 3.75 points	**LEARNING OBJECTIVE(S): C1, C2**
SAMPLE ANSWERS	
Part a: 1.75 points	

Sample answers include:

Sample 1

2015 Net Income =

=	Net EP	600
-	Net Inc Losses *	-555
-	Other U/W exp inc	-150
+	Net inv gain	+15
+	tot other inc	+10
-	Div to PH	-1
-	Fed inc taxes inc	-2
	Total	**-83 M**

* Net Inc Losses = Net Pd + Δ in Case Reserve
= 435 + 50 + (165+45-120-20)
= 555

Sample 2

Incurred Loss = 435 + (165-120) = 480
Incurred LAE = 50 + (45-20) =75

U/W Income = 600 - 480 - 75 - 150 = -105
Investment Income = 15
Other Income = 10 – 1 – 2 = 7

Net Income = -105 +15 + 7 = -83

Part b: 1 point

Sample answers include:

- One-year reserve development/prior year's PHS = 66/310 = 21.3% > 20%, so unusual. Is the company under reserving? If so, regulator may worry that balance sheet is weaker than it looks because reserves may be understated. Potential insolvency due to under reserving?
- Insurer has an unusual IRIS Ratio 3 ($\frac{855-520}{520} = 64\%$). This may indicate the insurer is growing too quickly and may be getting adversely selected against. This is troublesome since rapid growth is often a leading indicator of insolvency. If the insurer is growing too quickly, it may not be able to adjust rates quickly enough to curb the adverse selection. Additionally, the increase in volume will make it more difficult for the insurer to accurately estimate reserves due to volatility in business right now.

- GWP and NWP were the same in 2013 and 2014; however, this changed in 2015, indicating the insurer has entered into a reinsurance agreement – despite this level of protection GWPs doubled from 2014 to 2015, meaning the insurer is taking on more risks/expanding business. Additionally, PHS went down by $10M from 2014 to 2015 (represents -3.2% change from 2014). Lower surplus, in addition to more risks is concerning from regulator's POV. This could imply the insurer is gaining more business at the risk of conceding on something else (eg: rate) which only deteriorates financial condition of insurer.
- IRIS ratio 3 shows change in Net Written Premium: ($\frac{855-520}{520} = 64\%$). 64% is high above acceptable limit of 33%. Regulator may be concerned with this rapid premium growth since it is the most common symptom leading up to insolvencies. Insurer may be relaxing rates or underwriting standards to bring in cash quickly to pay current debt, but the risk accompanying all the premium may be more than insurer can handle.
- The company has been growing steadily since it began writing business IRIS ratio 1 and 2 have increased each of the last 2 years and IRIS ratio 2 for 2015 (855/300 = 285%) is approaching the threshold for unusual values. The company seems to be taking on more business without a corresponding increase in surplus. The fact that 1 year development in losses has drastically increased in the last year and is unusual (66/310 = 21%>20%) add to the concern for the regulator. The regulator may be concerned that the company may not have appropriately priced the line of business entered into.

Part c: 0.5 point

Sample answers include:

Description of Note:

- Includes disclosures on unsecured recoverable, uncollectible balances, retroactive reinsurance, run-off agreements, and others
- It discloses reinsurance recoverable > 3% of surplus and unsecured rec and reinsurance assumed and ceded which are significant

Why Regulator Might Consult Note:

- Regulator may look at unsecured recoverable to evaluate any potential credit risks to certain reinsurers
- The reg will want to see if this insurer has adequate reins protection to support their rapid growth

Part d: 0.5 point

Sample answers include:

- It appears this company just started using reinsurance so Schedule F could help the regulator assess the quality of the reinsures they are using as well as the collectability of the recoverables.
- Schedule F contains a section that shows the balance sheet gross of reinsurance. This can be analyzed to see if insurer is over-relying on reinsurance, has inadequate reinsurance, or is trying to distort financials to appear less risky.
- Schedule F indicates the provision for reinsurance carried by company. It's a liability item. More reinsurance results in higher provision -> increases liability -> decreases surplus.

EXAMINER'S REPORT

Candidates were expected to know the following:

- Items in an insurer's Annual Statement and how to utilize them
- Calculating IRIS ratios and knowing the usual ranges of these ratios

Part a

Candidates were expected to know the different components that contribute to net income which are U/W income, investment income, other income, taxes and dividends.

Common errors include:
- Using losses and LAE reserves directly from the balance sheet, as opposed to calculating the change in reserves
- Failing to include loss adjustment expenses in net incurred losses & LAE
- Removing investment expenses from the investment income component
- Assuming that taxes and dividends were already included in other income

Part b

Candidates were expected to fully discuss one concern a regulator might have by referring directly to the provided Annual Statement excerpt.

Common errors include:
- Describing rapid growth as a concern without providing numerical support
- Stating multiple concerns and attempting to relate them to each other
- Stating that investment expenses were too high. Investment expenses are not part of the balance sheet

Part c

Candidates were expected to briefly describe the content of Note 23 and why the content would attract a regulator's interest.

Common errors include incorrectly describing the content/intent of Note 23, such as:
- Stating that Note 23 contains provision for reinsurance
- Stating that Note 23 describes all reinsurance agreements
- Stating that the Note 23 shows financial ratings of reinsurers
- Stating that regulators can determine if the insurer is getting surplus relief from reinsurance

Part d

Candidates were expected to know contents of Schedule F (e.g., calculates provision, shows balance sheet gross of reinsurance) and how it helps regulators assess the strength of the balance sheet (e.g., provision is a liability and the higher it is, the more liabilities the insurer has).

Common errors include:
- Stating that Schedule F shows other U/W expenses
- Stating that Schedule F describes all reinsurance agreements
- Stating that regulator can assess if company has adequate capital to withstand its obligations through loss reserves