3. (2 points)

   a. (1 point)

      Identify and briefly describe two characteristics of the U.S. insurance regulatory system that limit regulatory failures.

   b. (1 point)

      Explain why each of the characteristics identified in part a. above may not be effective for Risk Retention Groups.

CONTINUED ON NEXT PAGE

- Driving under the influence (UBI can't detect this)
- High number of speeding tickets (already in rates and UBI can't detect this)
- Different drivers -i.e. Parents and several of their children. (UBI can't detect this)
- Driving carelessly (UBI can't detect careless driving in and of itself; a specific behavior needs to be exhibited in order for it to be detected)

Another common error was listing behavior that is related to UBI rating factors but is really a measure of miles driven, not risky behavior

- Lots of braking activity (it is quick and sudden braking that leads to higher premium, not frequency of using brakes)
- Frequency of lane changes (UBI might detect swerving at high speeds or sudden braking or acceleration, but normal lane changes are not a risk factor)

QUESTION 3

TOTAL POINT VALUE: 2	**LEARNING OBJECTIVES: A2, A3**

SAMPLE ANSWERS

Part a: 1 point

Identify any two of the following and provide a brief description for each.

Sample answers for Duplication

- Multiple states review the same insurer which minimizes the risk of not catching errors
- Both domiciliary state regulators and other state regulators that an insurer operates in will review financials of insurer to reduce regulator fallibility, or human error.
- Other states' regulators might catch insurers acting in concert or a mistake due to human error previously missed due to their authority to review & license any insurer conducting business in their state.

Sample answers for Peer Review

- Organizations like NAIC constantly review regulators' work to ensure no errors are made.
- The NAIC FAD helps the regulator to identify the potential financial-issued insurer.
- The NAIC's FAD performs continuous financial monitoring on significant insurers, and the NAIC accreditation process ensures that states regulatory system meets standards.

Sample answers for Peer Pressure

- If one state finds a company in need of additional scrutiny or other action, it will motivate other states to do the same. This prevents regulatory inaction.
- Non-domiciliary DOI's can pressure the domiciliary DOI to take action if necessary. This helps to eliminate regulatory forbearance.

Sample answers for Diversity of Perspective

- Influence from a multitude of state regulators allows for centrist solutions to regulation, as opposed to extreme views of over- or under-regulation.
- Having to have many state regulators compromise on solutions reduces the chance of regulatory capture and also results in less extreme outcomes.

Sample answers for Conservative assumption in accounting framework

- Helps encourage companies to hold more capital; helps minimizing frequency and severity of insolvency.
- SAP is a conservative accounting framework that was designed to signal trouble insurers before insolvency.

Sample answers for RBC/IRIS

- Early warning metrics like RBC and IRIS ratios allow regulators to detect companies at potential risk of insolvency early.
- Regulators use tools such as RBC and IRIS ratios to have consistent viewpoints in company's potential insolvency across the entire industry.

Part b: 1 point

Sample responses for Duplication

- RRGs are not as closely regulated by the states. They only have to be authorized by domiciliary commissioners. So, they have fewer parties to duplicate regulation.
- RRGs' reporting are not standardized like SAP. It needs specialized resources. This leads to increase cost to regulation.
- RRGs don't need to meet the same level of regulation in the states they operate, so there is less in-depth review of their practices and financial by multiple regulators.
- There is less regulatory barriers in non-domiciliary states. Risks inherent in the RRG might be overlooked. Duplication is not as effective.

Sample answers for Peer Review

- RRGs are very small usually. The FAD and FAWG might focus on larger, more impactful insurers.
- RRGs have less regulatory requirements on them, so there will be fewer instances where peers exist to check each other.

Sample answers for Peer Pressure

- Regulators in other states (not domiciliary) cannot as easily exert peer pressure as they must file an injunction to get the RRG to stop operating in their state.
- RRGs only have to be licensed in one state. Therefore, other states' DOI would not be able to revoke license, so peer pressure is less.
- Not so effective since different states regulate RRGs in different ways, e.g. different reporting/filing requirements. The lack of uniformity will reduce the ability to challenge.

Sample answers for Diversity of Perspective

- RRG's only have to be licensed in one state and then are allowed to operate in other states, only one state is the main evaluator. The main evaluator does not need to compromise with other states to move forward. This can result in more extreme decisions.
- Since RRG's are only required to be licensed in one state, they're likely to choose a state with relatively easy to work with regulators. This means under-regulation is more likely due to the lack of diverse perspectives.

Sample answers for Conservative assumption in accounting framework

- There is not uniformity in reporting requirements for RRGs. Some use GAAP, others use SAP. Makes it difficult for regulators to assess if not familiar with standard.
- Risk Retention Groups aren't subject to the same capital requirements as insurers, so regulation may be less effective in a stress event.

Sample answers for RBC/IRIS

- Since RRGs can file under GAAP, the tools such as IRIS and RBC are not meaningful.

EXAMINER'S REPORT

The candidates were expected understand the checks and balances that are in place to make sure the failures of a regulatory system don't happen. The question further tested a candidates' knowledge of the difference between how an insurer and a RRG are regulated and why the checks and balances for traditional insurers do not work for RRGs.

Part a

Candidates were expected to list two characteristics of regulatory checks and balances that help to prevent the failures of a regulatory system. They were also expected to provide a clear description of how or why each characteristic limits regulatory failure. Most candidates were able to identify appropriate characteristics.

Common errors include:

- Guaranty funds as a regulatory characteristic. The guaranty fund is a tool that is in place to limit the harm to policyholders after an insurer becomes insolvent not a check and balance that assists regulators in identifying troubled insurers
- Financial exams, rate filings, financial statements, and SAO. These are tools used by regulators to monitor company performance, not characteristics (attributes or qualities) of the regulatory system that provide checks and balances.
- Candidate successfully identified "peer review", but provided the definition of another type of checks and balances, usually duplication or peer pressure. Examples:
    - Insurers writing in multiple states are required to file their financial statements in all those states. Other state may catch an error.
    - Regulators in other states can put pressure on the regulator where an insurer is domiciled.

Part b

Candidates were expected to know the difference between how an insurer and a RRG are regulated and why the checks and balances listed in part a for traditional insurers do not work for RRGs.

Common errors include:

- Candidate did not provide enough details. ”RRGs are less regulated”
- Candidate lists the characteristic of RRGs, but failed to draw the connection to part a. “RRGs only need to be licensed in their state of domicile.” “RRGs are not subject to guaranteed fund.”
- Candidate interpreted the question as forming a RRG entity rather than regulating RRGs. “RRGs insure similar risks. Hence, there is no diversity of perspective”.
- Candidate had the wrong information about RRGs. “RRGs are subject to federal regulation.” “RRGs do not submit information to non-domicile states.”

QUESTION 4

TOTAL POINT VALUE: 3.25 | **LEARNING OBJECTIVE: A4**

SAMPLE ANSWERS

Part a: 0.75 points

Sample Response 1

- Direct or contractual relationship between insurer and insured; it was “transfer of risk”; it’s unique & specific only to the insurance industry

Sample Response 2

- Sharing or underwriting of risk; contractual relationship or agreement between insurer and insured; activities are exclusive to insurance entities

Sample Response 3

- Direct relationship between insurer and policyholder; practices limited only to the insurance industry; transfer of risk from insured to insurer

Sample Response 4

- Spreading of underwriting risk; direct connection between insurer and insured; activity specific to ins industry

Part b: 0.5 point

Sample Response 1

- Insurance was deemed to not be unique to each state. It is interconnected and interdependent between states; intangible products other than insurance had been regulated at the federal level

Sample Response 2

- Only a small percentage of SEUA companies domiciled in only one state; other intangible products sold across states are subject to Sherman act, so insurance should be as well

Sample Response 3