5. (2.25 points)

   a. (0.5 point)

   Identify two types of recoveries that a policyholder of an insolvent insurer may be entitled to receive from a state guaranty fund.

   b. (0.75 point)

   Briefly describe three potential limitations to a policyholder's recoveries from a state guaranty fund.

   c. (1 point)

   Fully explain whether a state guaranty fund is a desirable solvency backstop.

CONTINUED ON NEXT PAGE

Part f:
Candidates were expected to understand the role of federal oversight of insurance companies under the Dodd-Frank Act Common errors include: • Candidate did not acknowledge that reporting to the federal regulator (FIO) was only necessary upon request • Candidate did not specify that the relevant reporting was to be to the federal government. • Candidate did not understand that the living will applied to a receivership situation and was not a general plan of business to be submitted to the federal government • Confusing the requirements with the elements of a market conduct exam (submitting regular reports to state regulators, open books for audit, etc.) • Confusing the FIO's suggested directive from Dodd-Frank regarding things like international agreements and banking standards as things that the insurance companies are required to be involved in.

QUESTION 5	
TOTAL POINT VALUE: 2.25	**LEARNING OBJECTIVE: B2, B3**
SAMPLE ANSWERS	
Part a: 0.5 point	
Sample 1 UEP (unearned premium) and claims *Sample 2* • Unearned Premiums • Indemnity Payments *Sample 3* • Refund a portion of unearned premium • Collect on collision and comprehensive claims	
Part b: 0.75 point	

Sample 1
• Only applies to specific lines of business
   o Only P&C
   o Excludes lines like ocean marine, mortgage guaranty, title, etc
• Unearned premium recovery is limited to a specific recovery amount	

- Trigger of coverage – Court must officially rule that it's an insolvency before guaranty fund is paid out

Sample 2

- Claim deductible as well as a policy deductible
- Large net worth deductible
- Claims subject to limits (except WC which is unlimited)

Sample 3

- There may be a claim deductible to make sure a few claims don't deplete the fund
- There may be means testing to reduce payments to those who can afford to rectify their own damages
- Only certain types of insurance qualify for protection, like auto insurance, to allow the funds to be used in the coverages that need it most (excluding insurance like reinsurance or title insurance)

Sample 4

- May not get all of their UEPR returned
- Claims limits may be lower
- Types of coverage can be limited

Sample 5

- Claims are subject to a max (in addition to a policy limit) except for WC
- Only a portion of PHS UEP will be refunded
- If the insured is more affluent, then their claim/UEP will be low priority to be paid out by guaranty fund

Sample 6

- UEPR to refund but only to a certain limit
- Claim deductible in addition to policy deductible
- Large company may be subject to large net worth deductible

Part c: 1 point

Sample 1

Reduces incentives of policyholders to shop for financially strong insurers. It reduces the incentive to shut down weak insurers. Post-insolvency assessment can still cause market disruptions and costs are passed onto the policyholders. It also distorts competition allowing weaker insurers to gain market share by low-balling prices since consumers know the guaranty fund will protect them.

Sample 2

State guaranty funds are not desirable solvency backstops. In order to fund them, taxes are increased or insurers are charged a fee that is passed along to insureds. Having the fund as a backstop leads to a moral hazard where reinsurers and policyholders choose to do business with financially unstable insureds knowing that the risk is less given a guaranty fund payment if insolvency occurs.

Sample 3

They successfully return a portion of claim payments and UEPR to policyholders. They also motivate insurers to promote strong solvency regulation. However, the price of insolvencies is high because insurers are assessed directly for guaranty fund payments in event of an insolvency. Competition is distorted since insurers that aggressively underwrite or market can gain greater market share.

Sample 4

Yes. It ensures that policyholders could promptly receive most of their claims, in the event of insurer insolvency thus they are protected. Although it has some drawbacks, e.g. insurers are assessed directly to the fund, these assessments may be offset by estate of the insolvent insurer. It also faces the problem of distorting competition since insurers can relax their underwriting standards to gain market share. Its benefit of protecting policyholders outweighs the drawbacks thus it is desirable.

Sample 5

State guaranty funds are mostly desirable because they protect policyholders. However, policyholders and regulators rely on them too much. Policyholders ignore solvency of insurer and regulators delay intervention. There is also the mess of insurance across state lines – would federal guaranty fund be more or less fair?

Sample 6

Overall, yes. It limits the disruption in the insurance market for insurers/policyholders. It protects policyholders in the event of insurer insolvency. However, it is an imperfect approach. An insurer may charge inadequate rates in order to gain market share, and consumers may have less incentive to shop for strong insurers because of the backstop.

EXAMINER'S REPORT

The candidates are expected to have an understanding of the objectives, operations, and effectiveness of guaranty funds.

Part a

Candidates were expected to know the two types of recoveries that they may receive from a guaranty fund in the event that an insurance company becomes insolvent – which is the partial repayment of unearned premium reserve and the payment for most claims that would have been due under the insolvent insurer's policy.

Common mistakes included:

- Mention of loss adjustment expense as a source of recoveries (even in the context of loss and loss adjustment expense combined).
- Referencing a line of business (e.g. “Workers Compensation”) without any reference to loss recoveries.
- Mentioning that premium is reimbursed but not the unearned portion.
- Identifying the two forms of unearned premium reserve recoveries without reference to loss recoveries.

Part b

Candidates were expected to understand that the policyholder dollar recoveries from the state guaranty fund are limited.

Common mistakes included:

- Interpreting potential delays in guaranty fund payment as a limitation of recovery.
- Mentioning that the guaranty fund could be depleted without specifying any limitations to address this (such as a deductible or a limit).
- Confusing WC high deductible policies with large net worth deductibles.
- Confusing high income with high net worth with respect to the large net worth deductible.
- Mentioning recoveries associated with LAE, general expenses, or dividends.
- Confusing policy limit or deductible with the limit or deductible imposed by the guaranty fund.

Part c

Candidates were expected to provide four arguments either in favor or against the state guaranty fund as an effective backstop for insolvency. Candidates were not required to make a stance for or against guaranty funds, only make a comprehensive argument.

Common mistakes included:

- Evaluating a guaranty fund against the services provided by a solvent insurer. For example:
    - Arguing that recoveries are delayed when seeking money from a guaranty fund when it is faster relative to the bankruptcy process.
    - Arguing that recovery limitations are an argument against guaranty fund but not considering that the bankruptcy process may pay much less.
- Arguing against guaranty fund in that if funds run out, guaranty fund will not provide protection
- Stating that the guaranty fund increases moral hazard but not explaining why.

QUESTION 6	
TOTAL POINT VALUE: 1.75	**LEARNING OBJECTIVES: B2, B3**