7. (2.25 points)

   a. (0.5 point)

      Briefly explain two reasons why a financially strong insurer participating in a guaranty fund might prefer strong solvency regulation.

   b. (1 point)

      Describe two difficulties a guaranty fund might experience if a multistate insurer becomes insolvent.

   c. (0.75 point)

      If a state were to eliminate its guaranty fund, briefly describe a potential consequence to each of the following:

      i. Policyholders
      ii. Insurers
      iii. Regulators

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SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION: SPRING 2018 EXAM 6U, QUESTION 7	
TOTAL POINT VALUE: 2.25	**LEARNING OBJECTIVE: B3**
SAMPLE ANSWERS	

Part a: 0.5 point

Sample 1

1. The financially strong insurer does not want to have to be assessed to pay the policyholders of a different company that goes insolvent as this is costly. Strict regulation would help limit the number of insolvencies.
2. A weak insurer could underprice and have lax underwriting if it knows there's a "backup", the guarantee fund. This could decrease market share for the strong insurer as insureds may choose the cheaper option, especially if they know the guaranty fund is in place. Strong regulation can help avoid this scenario by requiring the weak insurer to charge adequate rates so it doesn't go insolvent.

Sample 2

1. The strong insurer would want competitors to also have strong solvency so they aren't at a competitive disadvantage (different costs of capital)
2. The strong insurer is unlikely to benefit from guaranty fund but still subject to assessments when another goes insolvent. High solvency standards limits this risk.

Part b: 1 point

Sample 1

1. It might be hard to generate enough in assessments to cover the losses. Assessments are generally capped, so an insolvency of a large insurer may require assessment over multiple years.
2. Since guaranty funds are at the state level it may be hard to allocate the insurer's remaining assets to the various states to help offset losses that would otherwise have to be covered by the guarantee fund.

Sample 2

1. The guarantee fund is a state level program. A multi-state insurer would have obligations in other states so the assets of the company wouldn't be fully available after the insolvency to any individual state fund.
2. Assessments have annual caps. A large multistate insolvency could require many years of assessments due to size.

Part c: 0.75 point

Sample 1

Policyholders would be more vulnerable to insolvencies and might move to financially strong insurers.
Insurers are more focused on solvency as it will attract more business
Regulators might enact more stringent solvency requirements to prevent insolvencies

Sample 2

Policyholders are not reimbursed if an insurer goes insolvent

Insurers can make a higher profit since they won't have to pay for costs of other insurers insolvencies
Regulators will be forced to scrutinize insurers more carefully since the policyholders have no protection if insurer goes insolvent

Sample 3
Policyholders: Reduced costs as premium will not include assessments.
Insurers: Mitigates moral hazard problems and puts strong insured on equal footing with weaker ones in terms of competition
Regulators: Greater focus on solvency regulation to prevent insolvencies.

EXAMINER'S REPORT

Candidates were expected to demonstrate the following concepts:

- What a guarantee fund is and how it's set up
- The purpose of a guarantee fund
- How guarantee funds impact the insurance industry
- The relationship between solvency regulation and guarantee funds

Part a

Candidates were expected to identify two different reasons why strong solvency regulation would be beneficial to a financially strong insurer.

Common errors included:

- Answering from the public's point of view. For example, wanting to ensure that policyholders were less likely to have to go through an insolvency from a weak insurer was not a sufficient motivator for a strong insurer.

Part b

Candidates were expected to demonstrate the connection between a large multi-state insolvency and the operations of a given guarantee fund.

Common errors included:

- Mixing up the insurers remaining assets with assessments.
- Implying that the payments to claimants happen at the national level.
- Stating a difficulty that either wasn't unique to a multi-state insolvency or wasn't a difficulty for an individual guaranty fund. The most common example of this type of mistake was stating that it would be difficult to determine which state pays which claims.

Part c

Candidates were expected to demonstrate that they understood the cause and effect relationship that the presence of a guaranty fund has on the insurance industry.

Common errors included:

- Stating the effect that insurers would become more financially stable without disclosing the cause/incentive.