2. (2.5 points)

   a. (0.5 point)

      Briefly describe two purposes of financial examinations by state insurance departments.

   b. (1 point)

      Explain how each of the following items may influence the minimum capital and surplus requirements for an insurer:

      i. Lines of business written

      ii. Ownership structure

   c. (1 point)

      Explain the difference between rehabilitation and liquidation of insurance companies.

CONTINUED ON NEXT PAGE

- Generic rationale but not relating it back to the Standards of Practice or CAS Principles on Ratemaking.

FALL 2018 EXAM 6US, QUESTION 2	
TOTAL POINT VALUE: 2.5	**LEARNING OBJECTIVE: A2**
SAMPLE ANSWERS	

Part a: 0.5 point

Any two of the following:

- To detect as early as possible those in financial trouble or in danger of going insolvent.
- To determine if the insurer is engaged in unlawful or improper activities, or to determine if the insurer is complying with rules and regulations. Specific examples would be to make sure the insurer's rates are not unfairly discriminatory, to make sure the insurer is not making excessive levels of profit, or to ensure sound investment decisions.
- To make sure the insurer's reserves are adequate.
- To develop information as a basis for regulatory action or to take action to mitigate issues with the insurer.
- To determine the effectiveness of the board of directors or management.
- To evaluate risk management practices and processes to mitigate risk.
- To determine the reliability of financial reports.
- To evaluate management information systems, IT process, and controls in place.
- To maintain NAIC accreditation.
- To compare companies across the industry and develop industry benchmarks.
- To prioritize which companies to focus on with more scrutiny.
- To ensure that insurers maintain sufficient liquidity and flexibility to meet their present obligations.

Part b: 1 point

Sample Responses for part i

- More hazardous lines need more capital because of potentially adverse loss exposure.
- More volatile lines need more capital because they are harder to estimate.
- Longer tailed lines need more capital because they are more volatile.
- Longer tailed lines need more capital because they have longer term investments and therefore more asset risk.
- CAT exposed lines need more capital because of the potential for adverse loss exposure.
- If several lines of business are written by the insurer, they can hold less capital than monoline insurers because of the diversification benefit.

Sample Responses for part ii

- Stock companies can hold less capital than reciprocal insurers because they have the ability to raise capital by selling stock.
- Subsidiaries require less capital because they can rely on a capital infusion from a strong parent company.

- Parent companies that own a large number of subsidiaries may need more capital in order to support the potential need for a capital infusion to one or more of their subsidiaries.
- Companies with a strong reinsurance program need less capital since they are less likely to go insolvent.
- Captives and RRGs have lower requirements due to the pooling relationships and the fact that they self-insure. Typically, there are adequate risk management practices and they are more knowledgeable about the risks they insure so capital requirements may be more relaxed.
- Insurers that own or are owned by a bank could have higher capital requirements as a result of the Dodd-Frank Act or FIO restrictions.
- RBC/ Minimum capital should not depend on the organizational structure of the insurance company. Investments in insurance subsidiaries that are subject to RBC do not provide diversification benefit.
- Alien insurers may have more stringent minimum capital requirements because the regulators do not have the same level of access to the insurer's operations.

Part c: 1 point

Rehabilitation means the insurer continues to exist. Potential actions to mitigate the problems associated with the rehabilitation include (one of the following):

- Find a capital infusion from investors or another company
- Protect the insurers assets from creditors
- Re-organize the insurer's finances
- Use assets to satisfy creditors
- Analyze the insurer's assets and liabilities and create a plan for paying creditors

Liquidation means the insurer ceases to exist. Additional actions taken include (one of the following):

- Assets are converted into cash to pay creditors
- Creditors are prioritized and paid
- Assets are transferred to another insurance company
- A guarantee fund is used to pay policyholder claims

EXAMINER'S REPORT

Candidates were expected to demonstrate knowledge of financial examinations, the effects of capital and surplus requirements on different types of insurers, and the possible outcomes of receivership.

Part a

Candidates were expected to identify and explain two distinct purposes of financial examinations.

Common errors include:

- Listing two items that are too similar. For example, stating financial exams are used to determine whether a company is in financial distress and also used to evaluate the solvency of the company.

- Stating that financial exams protect policyholders without describing how policy holders are protected (i.e. mentioning solvency).

Part b

Candidates were expected to explain how different lines of business affected the insurer's capital and surplus requirements. Candidates were also expected to explain how different ownership structures can results in different minimum capital and surplus requirements.

Common errors include (part i):

- Saying lines of business with high visibility or lines that are more important to the public may have different minimum capital requirements
- Saying long-tailed lines need more capital because they are riskier. The candidate was expected to explain why those lines are riskier (greater potential for adverse development).
- Saying long-tailed lines require less capital because of the additional investment income that can be earned.

Common errors include (part ii):

- Stating that foreign insurers (as opposed to alien insurers) may have more stringent minimum capital requirements because the regulators do not have the same level of access to the insurer's operations. Alien insurers are defined as insurance companies domiciled outside the United States. Foreign insurers are defined as insurance companies domiciled in another state but still within the US, where a regulator would have access to more information.
- Saying public companies require more capital to protect investors, to pay dividends, or to protect public interest. Minimum capital requirements do not take investors or the public into consideration. Companies may choose to hold more capital than is necessary in order to protect investors or pay dividends, but that is not reflected in minimum capital requirements.

Part c

Candidates were expected to identify the key differences between rehabilitation and liquidation.

Common errors include:

- Not identifying that rehabilitation involves continuing to exist and liquidation involves ceasing to exist. This is the key difference between the two.
- Saying rehabilitation involves reorganizing the insurer in order to continue operations.
- Saying liquidation results in insolvency as it is not the same thing as ceasing to exist. Both rehabilitation and liquidation could be results of insolvency.