23. (2.25 points)

a. (0.75 point)

Identify three reasons why most property and casualty insurance companies obtain financial strength ratings from one or multiple rating agencies even though they have no debt and are not publicly traded.

b. (1 point)

Briefly describe two advantages and two disadvantages for an insurance company to choose an interactive rating.

c. (0.5 point)

Briefly describe two shortcomings of rating agencies.

CONTINUED ON NEXT PAGE

QUESTION 23	
TOTAL POINT VALUE: 2.25	LEARNING OBJECTIVE(S): C2

SAMPLE ANSWERS

Part a: 0.75 point

Any three of the following:

- Agents may hesitate to place policies with the unrated insurers since they might be financially distressed.
- Some banks do not issue mortgages without property coverage from a rated insurer.
- Agents might be sued for providing insurance from a financially weak insurer.
- Primary insurers use ratings to evaluate the ability of reinsurers to pay obligations years in the future.
- Third-parties and consumers rely on outside assessments of insurer solvency.
- Rating agencies are efficient at assessing the financial strength of the insurer compared to most agents, underwriters and regulators, who may not have as much the time, experience or resources.
- It is less expensive to pay for a rating than to demonstrate financial strength individually to others.

Part b: 1.0 point

Advantages (any two of the following):

- It is less expensive to pay for a rating than to demonstrate financial strength individually to others.
- Insurer has some control over information reviewed
- Fewer chances of error
- Agents may be wary of insurers without an interactive rating
- Insurer can provide proprietary data, which allows for a more accurate rating
- Allow senior managers of the insurer to meet with the rating analyst to discuss the insurer's business strategy and experience with adverse scenario and handling of current company's problems

Disadvantages (any two of the following):

- It is time-consuming
- It is expensive
- It is intrusive

Part c: 0.5 point

Any one of the following:

- Rating agencies often do not respond as quickly as the bond and stock markets.
- Agencies hesitate to change rating too quickly.
- Agencies prefer to wait until they verify the new information.
- Conflict of interest: insurer pays rating agencies to rate their securities. Erroneous downgrades anger clients.
- Erroneous upgrades damage the agency's reputation with investors and agents.
- Investors are giving too much weight/reliance on the rating.

- Agencies may not be transparent with their methodologies

EXAMINER'S REPORT

Candidates were expected to demonstrate the importance of obtaining a financial strength rating from a credit agency.

Part a

Candidates were expected to demonstrate an understanding of the general benefits of obtaining an independent credit rating.

Common mistakes included:
- Some candidates misinterpreted the question as why insurers seek multiple credit ratings.
- The question stated the insurers have no debt and are not publicly traded; therefore points were not awarded for stating it helps insurers issue debt or it increases investors' confidence.

Part b

Candidates were expected to demonstrate an understanding of the benefits and drawbacks of an interactive credit rating.

Common mistakes included:
- Some candidates mentioned disadvantages of ratings in general, as opposed to specifically related to interactive ratings (e.g. agencies are slow to respond to market changes).

Part c

Candidates were expected to demonstrate an understanding of the general drawbacks of obtaining an independent credit rating.

Common mistakes included:
- Different agencies use different methodologies
- Failure of credit agencies in financial crisis
- Rating does not encompass every aspect of risk
- Model assumptions may not be appropriate