

EXAM 6 – CANADA, FALL 2018

22. (2.5 points)

A property and casualty insurance company has recently started writing an overland flood insurance coverage for personal property. The management of the company designs a stress testing program.

a. (0.5 point)

Explain how stress testing can be a key risk management tool for the insurance company's flood program.

b. (0.5 point)

Briefly describe two responsibilities of senior management in a property and casualty insurance company's stress testing program.

c. (1.5 points)

With respect to a stress testing program:

- i. Identify two areas of focus when designing the program.
- ii. Briefly describe each area identified in part i. above.
- iii. For each area of focus identified in part i. above, provide an example of how it applies to flood insurance.

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SAMPLE ANSWERS AND EXAMINER'S REPORT

QUESTION 22	
TOTAL POINT VALUE: 2.5	LEARNING OBJECTIVE(S): C2
SAMPLE ANSWERS	
Part a: 0.5 point	
<p><u>Sample 1</u> Stress testing is a key risk management tool during periods of expansion, when innovation leads to new products that grow rapidly and for which limited or no historical experience is available. Stress testing can be used to provide risk management and a control tool in the company's flood insurance program</p> <p><u>Sample 2</u> Stress testing can help identify concentrations and interactions between risks. For example, a stress test could test the concentration of home policies the insurer has written and insurers' response to a flood event.</p>	
Part b: 0.5 point	
<p><u>Sample answers (any two of the following):</u></p> <ul style="list-style-type: none"> • Responsible for implementation, management and oversight of the program • Identifying and describing the company's risk appetite • Understanding the impact of stress events on the risk profile of the company • Participating in reviewing and identifying potential stress scenarios • Contributing to the development and implementation of risk mitigation strategies 	
Part c: 1.5 points	
<p><u>Sample 1</u></p> <ul style="list-style-type: none"> • Focus 1 <ol style="list-style-type: none"> I. Risk mitigation II. Stress testing should facilitate the development of risk mitigation or contingency plans III. Example: Implement a reinsurance program to cover flood • Focus 2 <ul style="list-style-type: none"> ○ Reputation risk ○ An institution should enhance its stress testing methodologies to capture the effect of risks to reputation ○ Example: reputation risk if flood coverage is optional and was not offered to existing policyholders <p><u>Sample 2</u></p> <ul style="list-style-type: none"> • Focus 1 <ul style="list-style-type: none"> ○ Counterparty credit risk ○ An institution may have large gross exposures to leveraged counterparties ○ Example: credit risk from reinsurers • Focus 2 <ul style="list-style-type: none"> ○ Risk concentrations 	

SAMPLE ANSWERS AND EXAMINER'S REPORT

- Stress testing should consider risk concentrations resulting directly from risk taking activities as well as those resulting indirectly from actions to mitigate risks.
- Example: geographic concentrations in a high-risk flood zone

Sample 3

- Focus 1
 - Capital management
 - Considering the impact on the capital when designing the stress testing program
 - Example: capital response to a flood insurance event
- Focus 2
 - Liquidity risk
 - Stress testing should consider the insurer's ability to access or liquidate assets
 - Example: insurer's ability to access capital or liquidate assets in a flood event

Sample 4

- Focus 1
 - Multiple perspectives
 - Stress test design should include input from multiple departments within an organization (ex. underwriting, claims) as well as external subject matter experts
 - Example: insurer should engage experts (meteorologist, geologist, etc.) in designing the stress testing program
- Focus 2
 - Infrastructure for regular updates
 - Stress testing infrastructure should be flexible to regular updates in timing, scenarios, and risk factors
 - Example: Insurer can build stress test framework that can be updated regularly for flood plain data

EXAMINER'S REPORT

Candidates were expected to demonstrate a knowledge of stress testing and how to apply it to a flood insurance example.

Part a

Candidates were expected to explain how stress testing can be a key risk management tool for the insurance company's flood program.

A common error was:

- Omitting commentary relating the stress test program to flood insurance.

Part b

Candidates were expected to briefly describe two responsibilities of senior management in a property and casualty insurance company's stress testing program.

One common error was:

SAMPLE ANSWERS AND EXAMINER'S REPORT

- Candidates did not state their responsibility in the stress testing program. For example, saying that senior management was responsible to reporting to the board of directors.

Part c

Candidates were expected to identify two areas of focus when designing the program, describe each and relate them to flood insurance.

Common errors included:

- Outlining considerations of stress testing program design but not focuses. For example, documentation and data quality are not considered focuses.