22. (1.75 points)

a. (0.75 point)

Briefly describe three reasons most insurance companies require a rating by a recognized rating agency.

b. (1 point)

Identify two lines of business or types of insurance where high financial ratings are particularly important and briefly explain the reasons.

CONTINUED ON NEXT PAGE

QUESTION 22	
TOTAL POINT VALUE: 1.75	**LEARNING OBJECTIVE(S): C2**
SAMPLE ANSWERS	
Part a: 0.75 point	

Sample answers for reason #1

- Agents are wary about unrated insurer.
- Agents may hesitate to place policies with the unrated insurers since they might be financially distressed.
- Agents might be sued for providing insurance from a financially weak insurer.

Sample answers for reason #2

- Third party and customers rely on outside assessments of insurer solvency.
- Primary insurers use ratings to evaluate the ability of reinsurers to pay obligations years in the future.
- Investors use ratings to select companies to invest in.
- Solvency assessment: ratings used by regulators and agents to determine ability to pay claims.

Sample answers for reason #3

- Rating agencies are efficient at assessing financial strength.
- It is less expensive to pay for a rating than to demonstrate financial strength individually to various stakeholders.

Part b: 1 point

Any two of the following:

- Reinsurance: An insurer may be required to have reinsurance with a reinsurer of a high rating. This help to ensure the financial strength of the reinsurer.
- Low frequency/High severity type of insurance like surety: These types of lines are particularly difficult to insure because of their nature (harder to risk analyze & manage than high freq/low severity). A high rating may be required to demonstrate an insurer's ability to pay out.
- Homeowners insurance: Bank often required mortgage insurance from a highly rated insurance.

- Structured settlements: Court might require structured settlements issued from at least A level line insurance company to ensure that the claimant will receive the prescribed payments. It's a long-tail business for the insurer, so the rating is particularly important.
- Commercial liability because cash flow will continue a long time in the future. Company want to be sure insurer will be able to pay claims.
- Flood insurance: losses are concentrated, affecting large numbers of insured at once. Thus requiring high ratings to avoid insolvency.

Additional answers included other lines of business or types of insurance that were long tail line or low frequency/high severity, if a proper explanation was provided.

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 errors included:

- Repeating the same argument in different words
- Not providing the correct reason
- Not describing the reason correctly, for example:
  - "Third party requiring assessment" was not sufficient; candidates needed to mention the solvency assessment as well
  - Saying that "the management of the company does not have the expertise" is not correct as management should have the expertise, just not the resources required for a thorough review

Part b

Candidates were expected to describe lines of business or types of insurance where high financial ratings are important.

Common errors included:

- Not providing a line of business where a high rating is important (example: short tail line or high frequency/low severity)
- Repeating the same type of insurance in different words
- Not providing the correct justification
- Not providing a detailed justification, for example, answering "inherent risk" is not sufficient as the answer should relate to one of the following types risks:
  - Long tail lines: ability to pay when claims are due
  - High claims severity
  - Catastrophic events