

ERM-GH Model Solutions

Fall 2013

1. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.
4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

Learning Outcomes:

- (2c) Analyze and evaluate risk aggregation techniques, including use of correlation, integrated risk distributions and copulas.
- (2d) Apply and analyze scenario and stress testing in the risk measurement process.
- (4f) Develop an appropriate choice of hedging strategy for a given situation (e.g., reinsurance, derivatives, financial contracting), which balances benefits with inherent costs, including exposure to credit risk, basis risk, moral hazard and other risks.

Sources:

Value-at-Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion, Chapter 14, Stress Testing

Commentary on Question:

Commentary listed underneath question component.

Solution:

- (a) Evaluate the advantages of analyzing stress test results for the fixed and variable blocks separately versus in aggregate.

Commentary on Question:

Many candidates discussed one or two advantages, but focused mainly on analyzing the stress test results separately. For full credit, candidates were expected to compare advantages of separate testing versus testing in aggregate.

1. Continued

Analyzing the stress test results separately would allow Blackhawk to identify and analyze the risk drivers specific to each line of business. It could also identify the incremental impact of each line of business on the company's overall risk profile. Analyzing the stress test results in aggregate would consider any diversification benefits that exist between the two blocks. It could also identify the market movements or management actions that would have a material impact on the overall performance of the company.

- (b) Recommend four key unidimensional sensitivity tests that Blackhawk should run to analyze the risks of its business. Justify your response.

Commentary on Question:

Candidates were generally successful in providing adequate tests, though sometimes the justifications didn't match the test, or were not provided at all.

One common shortcoming was to provide a test that could not measure sensitivity, such as a more qualitative operational loss test.

The deferred fixed annuities in the question were intended to be accumulation-type annuities. However, some candidates assumed that they included income benefit guarantees and suggested mortality improvement as a sensitivity; candidates did receive credit for those recommendations, if justified.

1. Yield curve shift up: rates impact the discount rate for the reserves of the two blocks, as well as the assets backing the liabilities
2. Yield curve twist: this would measure the impact of key rate duration mismatches between the assets and liabilities
3. Equity market shock down: equity returns impact the VA guarantees and this test would measure the adequacy of the hedging program
4. Implied volatilities shock up: implied volatilities impact the assets backing the VA liabilities, and would also measure the adequacy of the hedging program

- (c) Blackhawk is also considering performing multidimensional scenario analysis.

- (i) Describe two types of multidimensional prospective scenarios.
- (ii) Explain the drawbacks of using each of the two types of scenarios identified in (i).
- (iii) Recommend one scenario of each type in (i) that would be meaningful to Blackhawk. Justify your response.

1. Continued

Commentary on Question:

Many candidates did not successfully identify the Factor Push Method and Conditional Scenario Method. Those who did generally performed well on the first two parts of the question. Part (iii) was challenging for all candidates, but well-formed justification of meaningful scenarios received credit.

- (i) Factor Push Method: First, push all risk factors individually up and down by a number of standard deviations and compute changes to portfolio. Second, evaluate a worst-case scenario where each variable is pushed in the direction that creates the worst loss.

Conditional Scenario Method: Group the key risk factors that are subject to extreme movements together, then group all other risk factors together. Regress the group of “other” risk factors on the group of key risk factors. This allows prediction of the “other” group of risk factors conditional on movements in key risk factors.

- (ii) Factor Push Method: This method is conservative as all risk factors are assumed to move in the direction that is most detrimental to the company. This method ignores correlation between risk factors. Looking at extreme movements may not be appropriate, as sometimes a loss may occur when an underlying risk factor doesn’t move at all.

Conditional Scenario Method: This method requires a sufficient amount of data to do the regression between the risk factors, and such data may not be readily available. The underlying correlation between risk factors in the data used to run the regression may not be homogenous (e.g. normal periods vs. periods of high market volatility) and could be misestimated.

- (iii) Factor Push Method: Shock volatility and credit default rates/downgrades up; shock interest rates, swap spreads, and credit spreads down; shock policyholder behavior in adverse direction. Each risk factor shocked 2.33 times standard deviation. These variables and associated shocks would produce the greatest loss for Blackhawk; 2.33 represents the 99th percentile, which should be sufficiently conservative.

Conditional Scenario Method: Group equity, interest rates and volatility together as the key risk factors group. Group all other risk factors together as the “other” group and regress the “other” group on the key risk group. Exclude policyholder behavior. Equity, interest rates and volatility data are most readily available and in sufficient volume. Swap and credit spreads are likely not significant enough to be placed in the key group. Policyholder data may not be sufficient or credible enough to include in regression.

1. Continued

- (d) Blackhawk reviews the stress testing results for the October 1987 Market Crash scenario and determines that these are unacceptable. As a result, Blackhawk proposes the following two approaches to manage the risks associated with severe equity market declines:
- (i) De-risk the product portfolio by changing product design
 - (ii) Hold sufficient capital

Describe the consequences for each of (i) and (ii).

Commentary on Question:

Candidates performed well on this section, offering substantial descriptions of the consequences of each approach.

- (i)
 - Could cause existing policyholders to lapse
 - Likely would impact marketing of the product
 - Likely would reduce competitiveness in the market
 - Potential regulatory barriers/risks
 - Could impact distribution channel
- (ii)
 - Provides greater buffer against all risks/reduces overall risk of insolvency
 - Could result in holding excessive level of capital
 - Adversely impacts profitability of products/shareholder returns
 - Adversely impacts competitiveness of product due to capital charge passed to policyholders

2. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

Learning Outcomes:

- (1a) Explain risk concepts and be able to apply risk definitions to different entities.
- (2a) Demonstrate how each of the financial risks faced by an entity can be amendable to quantitative analysis including an explanation of the advantages and disadvantages of various techniques such as Value at Risk (VaR), stochastic analysis, scenario analysis.
- (2c) Analyze and evaluate risk aggregation techniques, including use of correlation, integrated risk distributions and copulas.
- (2f) Analyze the importance of tails of distributions, tail correlations, and low frequency/high severity events.

Sources:

Value-at- Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion
Ch. 12 Monte Carlo Methods

Value-at- Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion
Ch. 5 Computing VaR

Commentary on Question:

This question tests the impact of tail dependence on a portfolio in the context of a stock portfolio. Candidates are asked to apply tail dependency concepts in determining the portfolio's VaR and to demonstrate knowledge of variance reduction techniques.

Solution:

- (a) Given the following formula:

$$\begin{bmatrix} \varepsilon_1 \\ \varepsilon_2 \end{bmatrix} = \begin{bmatrix} 1 & 0 \\ \rho & (1-\rho^2)^{1/2} \end{bmatrix} \begin{bmatrix} n_1 \\ n_2 \end{bmatrix}$$

- (i) Solve for ε_1 and ε_2 .
- (ii) Explain the purpose of this formula and how it works.

Commentary on Question:

Most candidates performed well on this part of the question.

2. Continued

$$\begin{aligned}\varepsilon_1 &= 1 \cdot n_1 + 0 \cdot n_2 = n_1 \\ \varepsilon_2 &= \rho \cdot n_1 + (1 - \rho^2)^{1/2} \cdot n_2\end{aligned}$$

Cholesky decomposition transforms the ε_2 variable such that it is dependent on the value of both n_1 and n_2 (i.e., it is correlated to ε_1). This process correlates two non-correlated variables (n_1 and n_2).

- (b) Determine the one year VaR(95%) for the portfolio value. Show your work.

Commentary on Question:

Many candidates did not calculate the VaR based on the simulated data that was provided. Instead, they used the 95% percentile z-value from the standard normal distribution. Such candidates did poorly on this part as the intent was for candidates to use the values provided in the question.

Various sources gave different definitions of the VaR calculation, so credit was awarded to candidates who selected the 19th or 20th ordered values (or interpolated between the two). Similarly, some candidates answered VaR as the difference between the expected portfolio value and that of the 19th simulation. Candidates were not penalized for this alternative definition.

*A few candidates noted that the simulated variables were not sorted appropriately in descending order in the table provided. It should be noted that it was the resulting **portfolio value** that was ordered and not the random variables.*

Find the ordered simulation that you need to evaluate to get VaR(95%). VaR is the highest loss such that there is at least a (1 - 95%) chance that the loss exceeds this amount. This is $21 \cdot .95$, rounded down to the nearest integer, which equals 19.

For the 19th simulation: $\varepsilon_1 = n_1 = -1.12$

Determine if the variables are correlated for simulation 19: $n_1 > -1.96$, so $\rho = 0$

For the 19th simulation: $\varepsilon_2 = \rho \cdot n_1 + (1 - \rho^2)^{1/2} \cdot n_2 = 0 \cdot (-1.12) + (1 - 0^2)^{1/2} \cdot (-1.05) = -1.05$

Holding XYZ value: $XYZ = 100 \cdot e^{((0.05 - 0.15^2/2) + 0.15 \cdot -1.12)} = 87.88$

Holding ABC value = $150 \cdot e^{((0.1 - 0.2^2/2) + 0.2 \cdot -1.05)} = 131.71$

Portfolio Value = $XYZ + ABC = 219.59$

2. Continued

- (c) Evaluate in qualitative terms (without performing additional calculations) the effect that each of the following changes would have on the VaR(95%) of the portfolio.
- (i) The correlation coefficient increases from 0.8 to 0.9 when $n_1 \leq -1.96$
 - (ii) Tail dependency is reflected when $n_1 \leq -2.65$ rather than when $n_1 \leq -1.96$

Commentary on Question:

The weakest candidates answered this question in general terms, without regard for the specific information provided for this portfolio. Stronger candidates answered this question by speaking directly to the impact these changes would have on the portfolio. The strongest candidates provided both portfolio specific responses as well as more general responses.

- (i) In general, an increase in the correlation triggers an even more adverse decrease in the value of the portfolio at the VaR (95%) level; however, because the correlation is zero when $n_1 > -1.96$, increasing the correlation does not impact the VaR(95%) in this sample.
 - (iii) Similarly to subpart (i), the 19th ordered statistic does not trigger the correlation at the lower threshold, so extending the condition further out to occur when $n_1 \leq -2.65$ has no impact on the VaR in this example. In general, however, this makes the correlation occur less often and therefore will make the VaR more favorable.
- (d) Explain the steps required to determine VaR(95%) for the portfolio value using the antithetic variable reduction technique.

Commentary on Question:

On this part, we were expecting candidates to delineate the process one would take to apply the antithetic variable reduction technique. Few candidates performed well on this section. Almost everyone identified the first step (i.e. multiply the original random variables by -1), but most skipped the majority of the steps and simply stated, "Calculate the VaR". Many candidates were able to identify that re-ordering was a step, but omitted the prior step of determining the portfolio value, making it difficult to determine whether they understood what exactly was supposed to have been ordered.

Step 1: Multiply each n_1 and n_2 by -1. This effectively doubles the sample size of the simulations.

Step 2: Calculate the resulting ϵ_1 and ϵ_2 for each ordered statistic.

2. Continued

Step 3: Calculate the resulting value of each holding, add these together to get the total value of the portfolio.

Step 4: Re-Order the portfolio values. The order may have changed because of the asymmetric correlation (i.e., it is only correlated for adverse scenarios).

Step 5: Calculate the ordered statistic(s) you need to find the VaR(95%). This is $42 \cdot .95$, rounded down, which = 39

Step 6: Identify the portfolio value of the 39th ordered statistic

- (e) Describe two additional variance reduction techniques and evaluate whether each is appropriate to use when modeling correlated equities.

Commentary on Question:

Most candidates performed well on this part. Almost all were able to identify and describe two techniques, but fewer justified whether or not each was appropriate.

Quasi-random sampling-

Stratify the distribution into equal probabilistic ranges. Then determine the value at the average point within each of the ranges.

With correlation, we could stratify the first holding (since $\mathcal{E}_1 = n_1$); however, the correlation makes it difficult to stratify the second holding and it is not recommended.

Importance Sampling-

Test only the portion of the distribution in which you are interested. For this example, we would test the tail at and around the 95th percentile.

This approach is tricky when considering multiple holdings (particularly when there is correlation) because a bad scenario could come from one performing poorly while the other performs well or from both performing poorly; therefore it is not recommended.

3. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
3. The candidate will understand how the risks faced by an entity can be quantified and the use of metrics to measure risk.

Learning Outcomes:

- (1b) Explain risk taxonomy and its application to different frameworks.
- (3b) Analyze and evaluate the properties of risk measures (e.g. Delta, volatility, duration, VaR, TVaR, etc.) and their limitations.

Sources:

ERM-105-12: Coherent Measures of Risk

Value-at- Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion
Ch. 5 Computing VaR

Commentary on Question:

Overall, the candidates did relatively well on this question. The question was testing the student's knowledge of a coherent risk measure and their understanding of the importance of using such a measure in economic capital calculations. While candidates could easily identify the coherent risk measures, they had some difficulty tying the given risk measures to the various properties of a coherent risk measure.

Solution:

- (a) Explain the benefits of satisfying each of the following properties when selecting a risk measure in the context of setting economic capital:
 - (i) Positive Homogeneity
 - (ii) Monotonicity
 - (iii) Translation Invariance
 - (iv) Subadditivity

Commentary on Question:

The candidates were able to define the properties of a coherent risk measure in part (a). Weaker candidates focused on a "mathematical explanation" and did not answer the question asked, which was to explain benefits of each of the properties in the context of setting economic capital.

3. Continued

There are two sources that could have been used for this question, as noted above. The explanations in the two sources differed in some respects; candidates could receive credit based on either of the sources.

- (i) Positive Homogeneity is a limiting case of subadditivity, representing what happens when there is precisely no diversification effect. Increasing the size of a portfolio by b should simply scale its required economic capital by the same factor. The units used (e.g., thousands or millions, US dollars or Euros) does not affect the economic capital measure.

Formula: For all $b \geq 0$ and random losses X , $\rho(bX) = b\rho(X)$.

- (ii) Monotonicity: If losses associated with one portfolio are always greater than losses associated with another portfolio, then the required economic capital associated with these portfolios should reflect this ordering.

Formula: If $X \leq Y$ for each scenario, then $\rho(X) \leq \rho(Y)$, where X, Y represent losses.

Alternatively, Monotonicity can also be stated as: when one portfolio has systematically lower returns than another portfolio for all states of the world, then its required economic capital should be greater.

Formula: If $X \leq Y$, then $\rho(X) \geq \rho(Y)$, where X, Y represent returns.

- (iii) Translation Invariance: Adding a known certain amount of loss to a random variable X increases the required economic capital by exactly that amount. This can simplify economic capital calculations when some losses are known or may be assumed to be constant.

Formula: For all random losses X and constants α ,
$$\rho(X + \alpha) = \rho(X) + \alpha.$$

Alternatively, Translation Invariance can also be stated as: Adding cash in the amount k to a portfolio should reduce the required economic capital by k .

Formula: $\rho(X + k) = \rho(X) - k$.

- (iv) Subadditivity reflects the benefit of diversification when combining portfolios. Combining portfolios could possibly decrease (but could not increase) the combined required economic capital.

3. Continued

Formula: For all random losses X and Y,
$$\rho(X + Y) \leq \rho(X) + \rho(Y).$$

- (b) Demonstrate whether the following properties are satisfied by the associated risk measures:
- (i) Positive Homogeneity - $\rho_1(X)$
 - (ii) Monotonicity - $\rho_1(X)$
 - (iii) Translation Invariance - $\rho_2(X)$

Commentary on Question:

Overall, the candidates had some difficulty with part (b). Many candidates were able to identify the risk measures and answered the question based on their knowledge of the risk measures' properties, rather than demonstrating the satisfaction of the particular properties for each specified risk measure. Some candidates demonstrated by providing examples of the various properties, which received either full or partial credit, depending on how complete the demonstration was. Other candidates demonstrated, by proof, how the risk measure was satisfied by the specified property, which received full credit.

- (i) Positive Homogeneity – $\rho_1(X)$: $\rho_1(X)$ is the VaR measure, which satisfies the property of positive homogeneity.
Definition: $\text{Probability}(X > \rho_1(X)) \leq 1 - .05$
If the entire random variable is scaled by b, then we have
 $\text{Probability}(bX > \rho_1(bX)) = \text{Probability}(X > \rho_1(X)) \leq 1 - .05.$
- (ii) Monotonicity – $\rho_1(X)$: $\rho_1(X)$ is the VaR measure, which satisfies the property of monotonicity. $\rho_1(X)$ is the smallest loss X such that the probability of a larger loss is no more than 5%. If $X \leq Y$, then $\rho_1(Y)$, the smallest loss Y such that the probability of a larger loss is no more than 5%, must be at least as large as $\rho_1(X)$; and since $\rho_1(X)$ and $\rho_1(Y)$ are monotonically increasing functions, then, $\rho_1(X) \leq \rho_1(Y)$.
- (iii) Translation Invariance – $\rho_2(X)$: $\rho_2(X)$ is the CTE measure, which satisfies the property of translation invariance.

3. Continued

$$\begin{aligned}
 \rho_2(X + c) &= E(X + c \mid X + c > \rho_1(X + c)) \\
 &= E(X + c \mid X + c > \rho_1(X) + c) \\
 &= E(X + c \mid X > \rho_1(X)) \\
 &= E(X \mid X > \rho_1(X)) + E(c \mid X > \rho_1(X)) \\
 &= E(X \mid X > \rho_1(X)) + c \\
 &= \rho_2(X) + c
 \end{aligned}$$

- (c) Determine which of the criteria in (a) are satisfied by $\rho_3(X)$. Show your work.

Commentary on Question:

The candidates also had difficulty with this part of the question. $\rho_3(X)$ is a hypothetical risk measure, not something candidates would have previously seen. Thus, the question was testing whether candidates understood the properties sufficiently to apply them in a new situation.

Positive Homogeneity

$\rho_3(X)$ does not satisfy the Positive Homogeneity criteria.

For example, assume $X \sim N(\mu, \sigma^2)$.

$$\text{Then } \rho_3(X) = (1/\alpha) \log(E[e^{\alpha X}]) = (1/\alpha) \log(e^{\alpha\mu + (\alpha^2)(\sigma^2)/2}) = \mu + \alpha(\sigma^2)/2.$$

$$\text{And } \rho_3(aX) = (1/\alpha) \log(E[e^{a\alpha X}]) = (1/\alpha) \log(e^{a\alpha\mu + (a^2)(\alpha^2)(\sigma^2)/2}) = a\mu + (a^2)\alpha(\sigma^2)/2$$

Since $\rho_3(aX)$ does not equal $a\rho_3(X)$, this criteria does not hold.

Monotonicity

$\rho_3(X)$ satisfies the Monotonicity criteria.

Assume $Y \geq X$. Then $e^{\alpha Y} \geq e^{\alpha X}$ and then $E[e^{\alpha Y}] \geq E[e^{\alpha X}]$

$$\text{Then } \log(E[e^{\alpha Y}]) \geq \log(E[e^{\alpha X}]) \text{ and } (1/\alpha)\log(E[e^{\alpha Y}]) \geq (1/\alpha)\log(E[e^{\alpha X}])$$

$$\text{Therefore } \rho_3(Y) \geq \rho_3(X)$$

Translation Invariance

$\rho_3(X)$ satisfies the Translation Invariance criteria.

$$\begin{aligned}
 \rho_3(X + a) &= (1/\alpha) \log(E[e^{\alpha(X+a)}]) = (1/\alpha) \log(E[e^{\alpha X} * e^{\alpha a}]) \\
 &= (1/\alpha) \log(e^{\alpha a} * E[e^{\alpha X}]) = (1/\alpha) (\log(e^{\alpha a}) + \log(E[e^{\alpha X}])) \\
 &= (1/\alpha) (\alpha a + \log(E[e^{\alpha X}])) = (1/\alpha)(\alpha a) + (1/\alpha)\log(E[e^{\alpha X}]) \\
 &= a + \rho_3(X)
 \end{aligned}$$

Subadditivity

$\rho_3(X)$ does not satisfy the Subadditivity criteria.

$$\rho_3(X + Y) = (1/\alpha) \log(E[e^{\alpha(X+Y)}])$$

$$\begin{aligned}
 \text{And } \rho_3(X) + \rho_3(Y) &= (1/\alpha) (\log(E[e^{\alpha X}]) + \log(E[e^{\alpha Y}])) \\
 &= (1/\alpha) \log(E[e^{\alpha X}] * E[e^{\alpha Y}])
 \end{aligned}$$

3. Continued

To satisfy subadditivity, $E[e^{\alpha(X+Y)}] \leq E[e^{\alpha X}] * (E[e^{\alpha Y}])$, but this is not true in general.

For example, if $X=Y$, define $Z=e^{\alpha X}$, then the above becomes $E[Z^2] \leq E[Z]^2$,

but $E[Z^2] > E[Z]^2$ for any non-degenerate Z .

- (d) Recommend a risk measure for Wrigley to use in its economic capital calculations, from the three proposed. Justify your answer.

Commentary on Question:

The candidates did very well on this part of the question. They generally knew which risk measure was a coherent risk measure and why. And quite a number of candidates knew why the other two risk measures were not coherent risk measures.

Recommend Wrigley uses $\rho_2(X)$.

$\rho_2(X)$, as the conditional tail expectation or the tail VAR, is a coherent measure of risk. It satisfies all four of the criteria given in part (a), which are properties we want our risk measure to have.

Both $\rho_1(X)$ and $\rho_3(X)$ were shown above to not satisfy some of the above criteria, so they are not coherent risk measures.

4. Learning Objectives:

4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

Learning Outcomes:

- (4c) Demonstrate means for transferring risk to a third party, and estimate the costs and benefits of doing so.
- (4f) Develop an appropriate choice of hedging strategy for a given situation (e.g., reinsurance, derivatives, financial contracting), which balances benefits with inherent costs, including exposure to credit risk, basis risk, moral hazard and other risks.

Sources:

ERM-108-12: Tiller, Chapter 5, Advanced Methods of Reinsurance

ERM-114-13: Introduction to Reinsurance

Commentary on Question:

This question tested the application of financial reinsurance concepts to a realistic scenario. This was a very high cognitive level question that involved comprehension and application rather than memorization and regurgitation. Overall candidates did poorly on this question. Many candidates could recall lists or information from the Tiller reading, but were unable to apply this information in the context of the question. In particular, candidates did very poorly on parts (f) and (g), with very few points being awarded for those sections.

In general, this question is a good example of what the ERM exam is attempting to assess. Candidates are equipped with a variety of concepts / tools presented in the syllabus. The most capable candidates are able to apply these tools to specific situations and recognize the effectiveness (or ineffectiveness) of these tools in the particular context of the question. Less capable candidates have difficulty applying the tools in contexts which are dissimilar to those presented in the syllabus.

Solution:

- (a) Provide arguments supporting the contention that the proposed agreement qualifies as a financial reinsurance transaction.

Commentary on Question:

Many candidates confused traditional reinsurance with financial reinsurance. They argued that there was significant risk transfer, which is necessary for a transaction to qualify as reinsurance for statutory and GAAP reporting purposes. With financial reinsurance, on the other hand, the main purpose is to attain a goal other than risk transfer, such as reserve relief. Most candidates missed this distinction.

4. Continued

Many candidates answered this subpart by describing features of the transaction that are sometimes related to financial reinsurance treaties (such as the recapture provision or risk charge) but failed to identify that there was limited risk being transferred (a required condition for financial reinsurance transactions). Partial credit was given for these feature-related types of responses. More credit was given to candidates who demonstrated an understanding that the primary purpose of financial reinsurance is typically not risk transfer and who were able to relate this to the specific transaction in the question.

The risk profile of the block of business suggests that risk transfer is not the primary objective of the transaction:

- The treaty is anticipated to be temporary in nature – E&J expected to recapture after 5 years if experience is as expected
- Low risk transferred to Hamsik – YRT reinsurance already in place covers mortality risk; reserves fully fund cash value benefits, therefore there is limited lapse risk; long duration asset portfolio appears to insulate the block from declining interest rates (as evidenced by the projected investment income)

In addition, the transaction contains several features common to financial reinsurance treaties:

- Experience refund
- E&J retains assets
- Recapture provision
- Risk charge provision
- Minimal cash flow expected to be exchanged between contracting parties

- (b) Identify the characteristics of the whole life block that make it a good candidate for a financial reinsurance transaction.

Commentary on Question:

Many candidates were able to recognize that the stable or sizable nature of the block made it a good candidate for financial reinsurance. Fewer candidates recognized that the limited risk of the block made it a good candidate for financial reinsurance.

Risk is minimal and projected cash flows are stable/sizeable:

- Inforce block – well defined liabilities in terms of scope and size
- Long history – experience studies can be performed, assumptions underlying block are credible
- Sizeable block – presumably stable experience
- High level of excess cash flows

4. Continued

- Already highly reinsured by YRT, which limits the mortality risk assumed by Hamsik
- (c) Identify and explain two benefits, one statutory and one economic, to E&J of entering into this transaction.

Commentary on Question:

Some candidates listed benefits without labeling them as statutory or economic. Depending on the strength of the response, partial or full credit was still given to these candidates. Other candidates mislabeled statutory benefits as economic benefits or vice versa. Some candidate confused responses to this question with responses to part (d).

Statutory Benefit:

RBC relief – the transfer of business to Hamsik means that Hamsik will hold the RBC for these liabilities. This improves the RBC ratio for E&J.

Economic Benefit:

Economic capital relief - In catastrophic scenarios, the business will not perform well and Hamsik will incur permanent losses under the terms of this agreement. This dynamic should result in lower economic capital requirements as E&J will be projected to suffer less severe losses under such catastrophic scenarios and it is precisely these types of scenarios which generate economic capital, i.e. tail scenarios.

- (d) Explain the benefits to both E&J and Hamsik of having this transaction be on a funds withheld basis as opposed to a coinsurance basis.

Commentary on Question:

Candidates did very well on this section. Some candidates did not distinguish between benefits to E&J and benefits to Hamsik, but credit was still given to these candidates since the wording of the question was somewhat ambiguous.

E&J:

- Do not need to sell assets and incur capital gains/losses
- E&J is exposed to less counterparty risk in relation to Hamsik
- Can maintain unified investment and dividend strategies
- Minimizes cash flows to be exchanged between contracting parties

4. Continued

Hamsik:

- Doesn't need to acquire large volumes of assets at current yields to back liabilities
- Doesn't need to manage assets or coordinate a dividend strategy with E&J
- Minimizes cash flows to be exchanged between contracting parties

- (e) Explain the importance of the following treaty provisions to E&J, and propose a formula to determine each for this proposed treaty.
- (i) Outstanding Surplus Account (OSA)
- (ii) Experience Refund (ER)

Commentary on Question:

Most candidates were able to obtain at least partial credit on this section. Many candidates were able to correctly describe both the OSA and the experience refund. Some candidates confused the OSA with the funds withheld account.

Many candidates were able to recall the OSA formula from the Tiller reading. Candidates who demonstrated understanding of the formula, but missed a sign or a component of the formula were awarded partial credit. There were two formulas given for the OSA calculation in the Tiller reading and full credit was given to candidates who listed either of these. The OSA formula given in the solution below was not explicitly given in the Tiller reading, but rather demonstrates understanding of the concept behind the OSA and would receive full credit.

Very few candidates earned any points for the experience refund formula.

Candidates who failed to provide an explicit formula but provided a conceptual explanation of the OSA and ER provisions (i.e., what these are intended to achieve) were awarded credit.

Importance of Outstanding Surplus Account:

The OSA would track any losses incurred by Hamsik as well as any uncollected risk charges (RC). It would be used to determine the amount of experience refund to be paid to E&J, i.e., no ER's paid while Hamsik is in a cumulative loss position. E&J could only recapture upon repayment or elimination of the OSA balance.

OSA formula:

$$\text{OSA}(0) = 0$$

$$\text{OSA}(t) = \text{OSA}(t-1) [1+r] + \text{Loss}(t) - \text{Paydown}(t)$$

4. Continued

Where

r is some interest rate negotiated between the parties as to what interest should accrue to losses funded by Hamsik

Loss(t) = is the loss incurred by Hamsik (including forgone risk charges) which will grow the OSA (note, the positive loss amount grows the OSA)
= if $[\text{Pre Tax Income}(t) - \text{RC}(t)] < 0$ then $-(\text{Pre Tax Income}(t) - \text{RC}(t))$
Otherwise 0

Gain(t) = is the gain on the reinsured block (net of the RC) which will go first to pay down any OSA balance and then to fund an ER
= if $[\text{Pre Tax Income}(t) - \text{RC}(t)] > 0$ then $\text{Pre Tax Income}(t) - \text{RC}(t)$
Otherwise 0

Paydown(t) = is the portion of the gain which is applied to reduce any OSA balance
= $\min[\text{OSA}(t-1) (1+r), \text{Gain}(t)]$

Alternative OSA formulas from the Tiller text:

OSA Ending Balance = OSA Beginning Balance + Statutory Gain – Investment Income on Surplus – Risk Charge

OSA Ending Balance = OSA Beginning Balance + Reinsurer Premium – Benefits – Reserve Increase – Experience Refund – Risk Charge

Importance of Experience Refund:

The ER would return all profits on the reinsured block to E&J in excess of the risk charge. It would be reduced by amounts needed to eliminate the OSA (if any). It gives E&J an incentive to practice prudent underwriting.

ER formula:

$\text{ER}(t) = \max [\text{Pre Tax Income}(t) - \text{RC}(t) - \text{Paydown}(t), 0]$

- (f) E&J has indicated that it is interested in obtaining some amount of statutory reserve relief.

Provide an estimated range for the amount of statutory reserve relief Hamsik would be willing to provide under the terms of this agreement. Justify your estimate and explain the process that Hamsik might follow in order to determine how much relief it is comfortable providing under the terms of this agreement.

4. Continued

Commentary on Question:

Candidates did very poorly on this section demonstrating a lack of familiarity with surplus relief transactions. In such transactions, Hamsik is essentially providing a loan to E&J which is secured by the future profits on the reinsured block of business. Only a handful of candidates understood this. If a candidate demonstrated understanding of this concept, but did not arrive at the estimated amount shown below, then partial credit was given. Many candidates responded that Hamsik would provide reserve relief on the entire reserve amount of \$512 million, a response that received no credit.

A few candidates were not able to arrive at a reasonable estimate of the reserve relief, but suggested that Hamsik consider the risks associated with the transaction/run stress tests/consider VaR. Some partial credit was awarded for these answers as well.

Estimated Range of Relief:

Hamsik will want to consider how much pre-tax profits are projected over the next 5 year period under best estimate and stress scenarios. This indicates the level of adversity that the block can sustain before Hamsik is exposed to the risk of not recouping the initial allowance extended to E&J.

To the extent that dividends will be reduced to absorb any adverse scenario experience, this should be considered as well (i.e., this should increase the amount Hamsik is willing to front). Assuming dividends absorb adverse experience impact then the maximum profit is approximately \$155M as this is the sum of profits – RC over the 5 year period.

Estimated Reserve Relief

$$\begin{aligned} &= \text{Sum (Pre-tax Income 2014-2018)} - 1\% * \text{Sum (End of Year Statutory Reserve 2014-2018)} \\ &= (39+37+36+35+34) - .01*(511+509+507+505+502) \\ &= \$155\text{M} \end{aligned}$$

Process to Determine Relief Amount:

- Hamsik should consider providing relief based on the amount which could be paid back over a 5 year period with some high level of assurance (i.e. high VaR)
- Hamsik would project treaty profits under stressed scenarios, determine how effective dividends are in mitigating the impact of adverse scenarios, and then determine how much they are comfortable extending to E&J.
- Hamsik will want to run adverse stresses and determine that under such stresses they are assured payback of any initial allowance they extend to E&J.

4. Continued

- (g) The pricing manager at Hamsik proposes increasing the risk charge to 1,000 basis points (instead of 500 basis points) at the end of five years to afford Hamsik increased protection against extremely adverse experience. Propose a response to the pricing manager

Commentary on Question:

Candidates did very poorly on this section as well.

Many candidates suggested that raising the risk charge to this amount may damage the relationship between E&J and Hamsik or that E&J may be more likely to either recapture the business or not enter into the agreement at all with a risk charge of this magnitude. These candidates missed that E&J planned to recapture the business at the end of 5 years in the first place and would not expect to pay this increased fee.

*From Hamsik's perspective, some candidates argued that the increased fee was not needed because the deal was **expected** to be recaptured. These candidates missed the point that Hamsik is attempting to structure a transaction which provides sufficient protection in adverse scenarios, i.e., risk management is focused on managing outcomes under adverse scenarios and not expected scenarios.*

Increasing the risk charge to 500 bps, as in the original proposal, already provides incentive to E&J to recapture the business. Having the increased charge instead be 1000 bps does not provide additional incentive (i.e., if the block is performing, E&J will want to recapture at 1000, 500 and probably even 150 bps depending on market pricing for reserve relief.) In extremely adverse scenarios, there will be experience losses at which point it does not matter what the risk charge is (i.e. Hamsik will not collect the risk charge no matter the level and E&J does not mind a large risk charge because it will never be paid since there are insufficient profits from which to pay it).

5. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.
4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.
5. The candidate will understand the concept of economic capital, risk measures in economic capital assessment and techniques to allocate the cost of risks within business units.

Learning Outcomes:

- (2h) Construct approaches to managing various risks and evaluate how an entity makes decisions about techniques to model, measure and aggregate risks including but not limited to stochastic processes.
- (4a) Evaluate the rationale for managing risk and demonstrate the selection of the appropriate risk retention level and hedging of risk.
- (4b) Demonstrate and analyze applicability of risk optimization techniques and the impact on an organization's value of an ERM strategy.
- (4d) Demonstrate means for reducing risk without transferring it.
- (4i) Analyze funding and portfolio management strategies to control equity and interest rate risk, including key rate risks. Explain the concepts of immunization including modern refinements and practical limitations. Contrast the various risk measures and be able to apply these risk measures to various entities.
- (5a) Describe the concept of economic measures of value and demonstrate their uses in the risk management and corporate decision-making processes.
- (5b) Define the basic elements and explain the uses of economic capital.

Sources:

Risk Appetite: Linkage with Strategic Planning Report

ERM-112-12: Revisiting the Role of Insurance Company ALM within a Risk Management Framework

Commentary on Question:

Candidates are expected to demonstrate an understanding of Risk Appetite Statements and their role in the ERM process. The concepts are examined at a general level and through analysis of a sample statement provided to the candidates. Most of the candidates did well in part (a).

5. Continued

Many candidates didn't do well in part (b) because, instead of explaining the rationale for the use of the metrics and their effect in business decisions, the candidates merely stated what the metrics are. Candidates are encouraged to read the questions carefully and understand the key words that tell them the expectations for the questions.

Solution:

- (a) Define Risk Appetite.

Commentary on Question:

Answers that convey the same message as any of the definitions listed below are acceptable. Candidates should understand and express in writing that a company sets risk preference in pursuit of its objectives, not just for the sake of risk taking.

- The total risk exposure an organization is willing to undertake in order to achieve its objectives.
- The amount of risk that an organization is willing to take on in pursuit of value.
- The maximum amount of risk a company is willing to accept in pursuit of its mission/objectives/plans.

- (b) Explain the rationale for including each of the metrics in Millenium's RAS and how they individually and collectively affect business decisions.

Commentary on Question:

Most of the candidates provided answers for individual metrics. Some, but not all, discussed their collective interaction, which is part of what the question required.

Some candidates showed confusion between Statutory Capital and Economic Capital. And many had difficulty explaining how the metrics would affect business decisions.

Excess Capital statement (item I) limits riskiness of liabilities and/or investments. Statutory accounting is not an accurate measure of economic return – so this metric may lead to business decisions focused more on statutory results rather than economic results

RoC statement (item II) limits excessive safe investments or business lines with inadequate returns. The shareholders require a minimum return for their risk of making an equity investment in the company, and this goal helps set the expectations for target returns. RoC minimum level requirement is fairly high in this economic environment, so this may encourage riskier investments / LOB's.

5. Continued

S&P goal (item III) is probably included as a requirement for at least two purposes: (i) so that the company remains attractive for new business / marketing purposes, and (ii) so the company holds adequate capital in order to maintain credit worthiness for capital-raising needs. The S&P rating reflects not only the financial metrics of the company, but a qualitative assessment of management and its ERM processes. Higher ratings secure the reputation and lower the cost of funds for a company.

Looking at the measures collectively, the RAS helps Millenium set target capital position, as well as the worst risk / return position expected on its capital. These measures require Millenium to maintain a balanced profile of being neither too aggressive nor too conservative.

- (c) Explain how the following stakeholders may view the existing RAS:
- (i) Millennium's Pricing Department
 - (ii) Regulators
 - (iii) Shareholders
 - (iv) Debt Holders

Commentary on Question:

Answers that convey the same message as the statements listed below or alternative ones with good reasoning were considered acceptable. However, a number of candidates provided weak statements that did not directly answer the question and, thus, received minimal points.

Depending on their background and experiences, candidates may have interpreted each individual component of the RAS as being either conservative or liberal. Either interpretation was acceptable, as long as the stakeholder views were consistent with the candidate's interpretation. The sample answer that follows assumes a "conservative" interpretation for the entire RAS.

- (i) Pricing area may find these restrictions make it difficult to compete with firms with looser risk appetite statements. The ROC requirement is a stretch target and the capital requirement restricts the riskiness of the product and supporting investments.
- (ii) Regulators would probably like these conservative criteria, since their primary concern is solvency.

5. Continued

- (iii) Shareholders may feel that these restrictions hinder the potential for large returns; as a result of the RAS, riskier product offerings or investments may be avoided.
 - (iv) Debt holders would probably like these conservative restrictions, as their ability to be re-paid depends upon the company's solvency.
- (d) Explain the implications of Millennium's approach to managing to its RAS by LOB.

Commentary on Question:

Candidates needed to provide and explain at least two implications to earn full credit. A few candidates were able to do that; most candidates only provided a single statement.

- Millennium would be able to execute its RAS, monitor business practices and compare results at the LOB level.
 - Millennium is probably managing to a considerably conservative level because it doesn't consider diversification across LOBs, i.e. assumes no diversification offset.
 - Millennium may be missing out on business or investment opportunities because the RAS items by LOB may not comply with the risk appetite statement, even though the company in total might still be able to meet the RAS requirements.
 - Holding too much capital can reduce return to shareholders.
- (e) During the 2008 financial crisis, Excess Capital dropped by 25% and ROC was -1% , but the risk limits have been consistently met since 2010.

Explain how Millennium's ERM department should have viewed this failure to satisfy the RAS and what actions, if any, should have been taken.

Commentary on Question:

None of the candidates provided a full-credit answer to this question. A candidate needed to express a view on the situation, with explanation, and indicate actions that should have been taken, if applicable, in order to receive full credit. The answers below are samples of appropriate responses; other reasonable answers could receive credit.

5. Continued

Millenium could view the 2008 crisis as a greater than 1 in 200 event, in which case it could argue that it was still passing the RAS criteria. In other words, do nothing.

Millenium could redefine its scenario construction if it considered 2008 as less than a 1 in 200 event, i.e. revisit its modeling approach and scenario assumptions in order to capture such events in its capital requirements.

Millenium could have de-risked its business via numerous possible methods:

1. Try to shift its investment portfolio to "safer" investments, assuming it could do so and still meet the minimum investment returns.
2. Try to exit out of (or reduce exposure to) riskier LOBs that were the primary contributors to this negative result.

6. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

Learning Outcomes:

- (1c) Identify and analyze risks faced by an entity, including but not limited to market risk, currency risk, credit risk, spread risk, liquidity risk, interest rate risk, equity risk, hazard/insurance risk, inflationary risk, environmental risk, pricing risk, product risk, operational risk.
- (4b) Demonstrate and analyze applicability of risk optimization techniques and the impact on an organization's value of an ERM strategy.
- (4k) Analyze methods of managing other risks (operational, strategic, legal and insurance) both pre-event and post-event

Sources:

Financial Enterprise Risk Management, Sweeting, Chapter 8 Risk Identification

SOA Monograph – A New Approach to Managing Operation Risk, Chapter 8

ERM-107-12: Strategic Risk Management Practice, Anderson and Schroder, 2010, Chapter 7

Commentary on Question:

In general this question was well done. Many candidates were able to obtain some points because survey questions and potential shortcomings could come from their general knowledge base. The higher scoring candidates were able to go more in depth and could tailor their responses to the specific situation presented.

Solution:

- (a) Currently Dearbourne uses the following practices to identify its top operational risks:
 - I. Survey managers
 - II. Use external data – i.e., Expert/Industry surveys
 - III. Use internal data

Identify the potential shortcomings with each of these practices.

6. Continued

Commentary on Question:

Subpart (a) was done relatively well. Many candidates were able to identify at least two shortcomings for each risk identification process, which is what was required for full credit.

Survey Managers: Managers could be too close to their business and might miss risks that are not observable and have not happened yet. Also, managers may not have broad enough experience to have a sense of the likelihood and severity of the risks.

Use of External Data: External surveys may miss operational risks that are specific to the company, and, conversely, external data may not apply to Dearbourne. Also, the cost of obtaining external data may be large.

Use of Internal Data: May not contain enough data or data specific to the company to fit credible distributions when looking at heavy tailed events. Internal data may have biases or may not be in a useable form, for example, anecdotal or qualitative data.

- (b) Outline the objectives you intend to achieve in conducting these surveys.

Commentary on Question:

Candidate responses on subpart b) were adequate, but not sufficient for full credit in most cases. Many candidates missed the idea that the survey objectives could be used to get a sense of the likelihood and severity of operational risks.

Objectives include the following:

Risk Identification - Identify risks facing the company and the manager's particular department

Quantify risks - Determine the likelihood of risks or frequency/severity, rank risks, and fit aggregate distributions

Determine the best ways to manage risks

- (c) The following managers are among those selected to be surveyed.

- I. Building Security Manager
- II. Chief Information Officer
- III. Chief Officer of Quality Control

Propose key survey questions specific to each manager.

6. Continued

Commentary on Question:

This subpart was well done by many candidates. Some candidates, however, suggested questions that were too general (not related to the manager being surveyed) or that did not relate to operational risks. Candidates who provided three appropriate and distinct questions for each manager could receive full credit.

Some candidates did not understand that a Chief Information Officer is normally the manager responsible for Information Technology (IT). If candidate responses indicated a different interpretation of this position, credit was still given for questions appropriate to that position.

Building Manager:

- Determine ease of access to building - Who can access the building, could a competitor get in and steal information?
- People risk - Determine current employee access to certain places in building - What prevents employees from gathering info from other departments?
- Determine the ability of employees to leave with certain documents/ technology, etc. What procedures exist to deter employee theft of confidential data or technology?

Chief Information Officer:

- Determine quality of the security surrounding computer information. How can the system be compromised by hacking or by other methods?
- People Risk - How can employees be prevented from transmitting proprietary information?
- Technology Risk – What gaps are in the system such that data could be compromised by a technological failure?

Chief Officer of Quality Control

- Process Risk - What are the controls over the manufacturing processes?
- Process Risk – Where have controls failed in the past and how can they be improved? How do you measure process failure?
- People Risk – Are staff members aware of the controls and following them? How do you evaluate this?

6. Continued

(d)

- (i) Explain how a conditional viewing on the evolution of wearable technology could help identify Dearbourne's competitive risks.
- (ii) Provide four specific examples of information that Dearbourne might obtain by using this approach.

Commentary on Question:

This question was reasonably well done. Many candidates could provide specific examples of conditional viewing. In subpart (i) some candidates missed the idea that conditional viewing involves using pre-selected information to provide specific insights.

The definition of conditional viewing is provided in the response below for educational purposes. The question did not ask candidates for the definition so it was not required for full credit.

- (i) Conditional viewing involves tracking pre-selected information from particular sources focused on the topic of wearable technology. This would provide Dearbourne with specific insights as to the direction of new wearable technology products that could threaten the company's existing products.
 - (ii) Could identify what wearable technology is emerging i.e., Wristwatches, Eyeglasses, gloves etc.
Could identify what customers would like in a wearable technology
Could identify extra costs of switching possible current products to wearable tech
Could identify new technology that is needed to produce wearable technology.
- (e) Explain how undirected viewing of the current technology environment could help identify Dearbourne's competitive risks.

Commentary on Question:

Many candidates understood that undirected viewing is a broad based view; however some candidates did not sufficiently describe how a broad based view could be advantageous to Dearbourne.

The definition of undirected viewing is provided in the response below for educational purposes. The question did not ask candidates for the definition so it was not required for full credit.

6. Continued

An undirected view is an approach whereby the corporation follows various informational sources without any specific objectives in mind in order to find emerging trends.

This broad based view might identify new trends that competitors have not seen; it might identify potential company acquisitions; it might suggest areas for further research.

7. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

Learning Outcomes:

- (1c) Identify and analyze risks faced by an entity, including but not limited to market risk, currency risk, credit risk, spread risk, liquidity risk, interest rate risk, equity risk, hazard/insurance risk, inflationary risk, environmental risk, pricing risk, product risk, operational risk.
- (4a) Evaluate the rationale for managing risk and demonstrate the selection of the appropriate risk retention level and hedging of risk.
- (4b) Demonstrate and analyze applicability of risk optimization techniques and the impact on an organization's value of an ERM strategy.
- (4d) Demonstrate means for reducing risk without transferring it.

Sources:

ERM-509-13: PPACA MLR Regulations

ERM-502-12: Healthcare Reform's Minimum Medical Loss Ratios

ERM-504-12: Mapping of Health Company Risks

ERM-511-13: PPACA 3R's Programme Description

Commentary on Question:

Commentary listed underneath each question component.

Solution:

- (a) Calculate the large group and small group minimum loss ratio rebate for Active Choice.

Commentary on Question:

The question tests the candidate's knowledge of the minimum loss ratio rebate formula. Full credit is awarded for understanding the formula and performing the calculation correctly. Partial credit is awarded for understanding the formula. Candidates generally did well on this section.

7. Continued

Small Group Calculation

$$SGRebate = AdjSGPrem \times \max[0, 80\% - (AdjSGLR + SGCredAdj)]$$

where

$$SGRebate = \text{Small Group Rebate}$$

$$\begin{aligned} SGPrem &= \text{Small Group Premium} \\ &= \$156.2 \text{ million (from the case study)} \end{aligned}$$

$$\begin{aligned} SGTLF &= \text{Small Group Taxes, Licenses and Fees} \\ &= SGPrem \times \frac{\text{Total Taxes, Licenses and Fees}}{\text{Total Premium}} \\ &= \$156.2 \times \$9.2 / \$307.2 \text{ (all figures from the case study)} \\ &= \$4.7 \end{aligned}$$

$$\begin{aligned} AdjSGPrem &= \text{Adjusted Small Group Premium} \\ &= SGPrem - SGTLF \\ &= \$156.2 - \$4.7 \\ &= \$151.5 \end{aligned}$$

$$\begin{aligned} SGLosses &= \text{Small Group Losses including the cost of activities to improve} \\ &\quad \text{quality of care} \\ &= \$139.1 \text{ (from case study and assumptions provided)} \end{aligned}$$

$$\begin{aligned} AdjSGLR &= \text{Adjusted Small Group Loss Ratio} \\ &= \frac{SGLosses}{AdjSGPrem} \\ &= \$139.1 / \$151.5 \\ &= 91.8\% \end{aligned}$$

$SGCredAdj$ = Small Group Credibility Adjustment, which is a linear interpolation of the credibility factors in the credibility table provided based on member-years

$$\begin{aligned} \text{Small Group Member-Years} &= \text{Small Group Member-Months}/12 \\ &= 305,752/12 \text{ (from case study)} \\ &= 25,479 \end{aligned}$$

Linearly interpolating from the table provided:

$$\begin{aligned} SGCredAdj &= 0.012 \times \frac{25,479 - 25,000}{25,000} + 0.016 \times \frac{50,000 - 25,479}{25,000} \\ &= 0.0159 \end{aligned}$$

7. Continued

Therefore,

$$\begin{aligned}SGRebate &= \$151.5 \times \max[0, 80\% - (91.8\% + 1.59\%)] \\ &= \$0\end{aligned}$$

Large Group Calculation

$$LGRebate = AdjLGPrem \times \max[0, 85\% - (AdjLGLR + LGCredAdj)]$$

where

$$LGRebate = \text{Large Group Rebate}$$

$$\begin{aligned}LGPrem &= \text{Large Group Premium} \\ &= \$151.0 \text{ million (from the case study)}\end{aligned}$$

$$\begin{aligned}LGTLF &= \text{Large Group Taxes, Licenses and Fees} \\ &= LGPrem \times \frac{\text{Total Taxes, Licenses and Fees}}{\text{Total Premium}} \\ &= \$151.0 \times \$9.2 / \$307.2 \text{ (all figures from the case study)} \\ &= \$4.5\end{aligned}$$

$$\begin{aligned}AdjLGPrem &= \text{Adjusted Large Group Premium} \\ &= LGPrem - LGTLF \\ &= \$151.0 - \$4.5 \\ &= \$146.5\end{aligned}$$

$$\begin{aligned}LGLosses &= \text{Large Group Losses including the cost of activities to improve} \\ &\quad \text{quality of care} \\ &= \$104.3 \text{ (from case study and assumptions provided)}\end{aligned}$$

$$\begin{aligned}AdjLGLR &= \text{Adjusted Large Group Loss Ratio} \\ &= \frac{LGLosses}{AdjLGPrem} \\ &= \$104.3 / \$146.5 \\ &= 71.2\%\end{aligned}$$

LGCredAdj = Large Group Credibility Adjustment, which is a linear interpolation of the credibility factors in the credibility table provided based on member-years

$$\begin{aligned}\text{Large Group Member-Years} &= \text{Large Group Member-Months}/12 \\ &= 464,446/12 \text{ (from case study)} \\ &= 38,704\end{aligned}$$

7. Continued

Linearly interpolating from the table provided:

$$\begin{aligned} LGCredAdj &= 0.012 \times \frac{38,704 - 25,000}{25,000} + 0.016 \times \frac{50,000 - 38,704}{25,000} \\ &= 0.0138 \end{aligned}$$

Therefore,

$$\begin{aligned} LGRebate &= \$146.5 \times \max[0, 85\% - (71.2\% + 1.38\%)] \\ &= \$18.2 \text{ million} \end{aligned}$$

- (b) Calculate the risk corridor payment that Active Choice would have received if it had participated on an Exchange in 2011.

Commentary on Question:

The question tests the candidate's knowledge of the risk corridor payment formula. Full credit is awarded for understanding the formula and performing the calculation correctly. Partial credit is awarded for understanding the allowable cost target portion of the formula, and partial credit is awarded for understanding the remainder of the formula. Candidates generally did not do well on this section. Most did not understand the risk corridor formula.

Using the notation from part (a):

$$\begin{aligned} ACT &= \text{Allowable Cost Target} \\ &= 80\% \times AdjSGPrem \\ &= 80\% \times \$151.5 \\ &= \$121.2 \end{aligned}$$

$$CP = \begin{cases} \$0 & \text{if } SGClaims < 103\% \times ACT \\ 50\%(SGClaims - 103\% \times ACT) & \text{if } 103\% \times ACT < SGClaims < 108\% \times ACT \\ 50\% \times 5\% \times ACT + 80\%(SGClaims - 108\% \times ACT) & \text{if } SGClaims > 108\% \times ACT \end{cases}$$

The ratio of $SGClaims$ to ACT , $\$139.1/\$121.2 = 114.8\%$, which exceeds 108%; therefore, the third formula above applies.

$$\begin{aligned} CP &= 50\% \times 5\% \times \$121.2 + 80\% \times (\$139.1 - 108\% \times \$121.2) \\ &= \$9.6 \text{ million} \end{aligned}$$

7. Continued

- (c) You are evaluating the impact of the following four changes required by ACA on pricing, operational, and regulatory categories of risks:
- I. Minimum loss ratio rebates in the small group and large group market
 - II. Small group risk adjustment program
 - III. Participation on the Exchange to achieve growth in the small group business
 - IV. Rate filing requirements
- (i) Provide two examples of specific risks for each of the four changes.
- (ii) Identify for each of the examples provided in (i) whether it is a pricing, operational, or regulatory risk.

Commentary on Question:

Full credit is awarded for any risk that is identified correctly as pricing, operational, or regulatory and is a direct result of ACA. Providing appropriate risk examples is more important than classifying the risks properly. Candidates generally did well on this section, identifying most of the risks caused by these ACA changes.

The responses below provide more than two examples for each change, in order to serve as a learning tool. Only two correct examples were needed for each change in order to get full credit.

Risks created by ACA:

- I. Minimum Loss Ratio Rebates
 - Pricing risk - can no longer subsidize the small group market with the large group market
 - Pricing risk – can no longer subsidize poor years with good years
 - Operational risk – may not be able to complete reporting in an accurate and timely manner
- II. Small Group risk adjustment program
 - Operational risk – claim system may not have data needed to calculate risk adjustment factors
 - Operational risk – network providers may not code diagnosis accurately enough for risk adjustment calculation

7. Continued

- Pricing risk – operational risks along with difficulty in predicting risk adjustment transfers can cause mispricing
- Pricing risk – risk adjustment factors may not compensate insurers appropriately
- Regulatory risk - cannot meet federal reporting requirements

III. Participation on the Exchange to achieve small group growth

- Pricing risk – having rates out on an Exchange for all to see can cause a “run on the bank” if rates are too low
- Operational risk – because of the new ACA fees and assessments, commissions might have to be reduced which may cause unhappiness among the brokers
- Operational Risk – plans are not currently URAC or NCQA approved, and that process will require time and effort that may disrupt everyday operations. In addition, Active Choice might have to make changes to achieve accreditation
- Operational risk – “back-end” systems won’t communicate with insurers
- Pricing risk - participation on the Exchange will be low and will not cover expenses
- Pricing risk – participation on the Exchange may have poor risk characteristics
- Regulatory risk – must comply with new rules to participate on the Exchange

IV. Rate Filing Requirements

- Regulatory risk – needed rate increases may not be approved under the current rules
- Pricing risk – there’s a longer lag between experience period on which rates are based and effective date
- Operational risk - filings become too expensive and difficult to complete properly

- (d) You have been asked to recommend strategies that AHA and Active Choice, if merged, could use to mitigate the risks resulting from the four ACA changes in (c). You have been told to not consider reinsurance in your recommendations.

Explain the risk mitigation strategy that you feel would be most effective for each of the four changes. Justify your selection.

7. Continued

Commentary on Question:

Full credit requires a well-explained risk mitigation strategy and justification as to why it is effective. The strategies and justification must be for the eight risks identified in part (c). Avoiding a risk entirely is not a legitimate risk mitigation strategy (e.g., avoid the risk of the Exchange by not participating on the Exchange). Candidates struggled with this section. ACA is a new area of practice and risk mitigation strategies are still developing.

The sample answer below again discusses more than the required eight risks. In some cases, it provides more than one mitigation strategy for each risk as a learning tool. Only one mitigation strategy was required to obtain full credit.

Minimum Loss Ratio Rebates

- Pricing risk – can no longer subsidize the small group market with the large group market.

Mitigation strategies:

- redesign all management reports to be market specific so that small and large group products can be managed to be self-sufficient,
 - add margin in rates to stay below the MLR, reducing the likelihood that small group will need a large group subsidy,
- Operational risk – may not be able to complete reporting in an accurate and timely manner.

Mitigation strategies:

- use AHA staff (they are in 15 states), assuring that sufficient resources are available,
- use an outside vendor for all ACA related reporting, assuring that sufficient resources are available

Small Group risk adjustment program

- Operational risk – claim system may not have data needed to calculate risk adjustment factors.

Mitigation strategies:

- use AHA claim system, which is known to have the data needed,
 - use consultants to help improve current claim system, assuring that the system tracks the needed data
- Operational risk – network providers may not code diagnosis accurately enough for risk adjustment calculation.

7. Continued

Mitigation strategies:

- start education program with doctors in Networks 'R us so that they understand ACA expectations,
 - use AHA provider contracting staff to help communicate with doctors so that ACA requirements are reinforced,
 - use AHA staff to help Active Choice find another network that is known for compliance
- Pricing risk – difficulty in predicting risk adjustment transfers can cause mispricing.

Mitigation Strategies:

- purchase risk adjustment model from consulting firm and calculate risk adjustment factors for Active Choice business, reducing prediction error,
 - contact NY insurance department for statewide average risk adjustment factor in order to see where Active Choice stands compared to statewide norms,
 - add margin to rates until risk adjustment transfers are better known so that potential gains are more likely to be shared (as opposed to hoping that losses will be fully compensated)
- Pricing risk – risk adjustment factors may not compensate insurers appropriately.

Mitigation Strategy:

- model financial gain from marketing to sick members, receive a risk adjustment transfer for those members, and manage their costs better than predicted by the risk adjustment transfer, which assures that the transfer is fully adequate.
- Pricing risk - cost of complying with risk adjustment program might be high.

Mitigation Strategy:

- use AHA expertise (they also must comply) or outside vendor, assuring that costs are well-managed.
- Regulatory risk - cannot meet federal reporting requirements.

Mitigation Strategy:

- use AHA compliance expertise or outside vendor, assuring that federal requirements are met.

7. Continued

Participation on the Exchange to achieve small group premium growth

- Pricing risk – having rates out on an Exchange for all to see can cause a “run on the bank” if rates are too low.

Mitigation Strategy:

- monitor competitor plan and pricing to ensure Active Choice plans are comparable (not too rich) so that a “run on the bank” is unlikely,
 - terminate some small group broker relationships or reduce commissions to control distribution, reducing Exchange exposure
 - pay more commission for large brokers to incent them away from small group, reducing Exchange exposure
- Operational Risk – because of the new ACA fees and assessments, commission might have to be reduced, which will cause unhappiness among the brokers.

Mitigation strategies:

- terminate brokers who focus on small group since the exchange will make them less necessary and thereby lower commission expenses
- Operational Risk – plans are not currently URAC or NCQA approved, and that process will require time and effort that may disrupt everyday operations. In addition, Active Choice might have to make changes to achieve accreditation.

Mitigation strategy:

- use AHA staff or consultants to help facilitate approval by URAQ and NCQA, increasing the chances of approval
- Operational risk – “back-end” systems won’t communicate with insurers.

Mitigation strategy:

- establish manual process as a back-up plan.
- Pricing risk - participation on the Exchange will be low and will not cover expenses.

Mitigation strategy:

- combine administration with AHA to save expenses.

7. Continued

- Pricing risk – participation on the Exchange may have poor risk characteristics.
Mitigation strategy:
 - design plan options to be comparable to other carriers (not richer) and implement a marketing plan that appeals to Active Choice’s target market, increasing the likelihood of obtaining a standard population.
- Regulatory risk – must comply with new rules to participate on the Exchange.
Mitigation strategy:
 - use AHA compliance staff expertise and/or outside vendor

New Rate Filing Requirements

- Regulatory risk – needed rate increases may not be approved under the current rules.
Mitigation Strategy:
 - add margin to rates so that future rate increases are not as large,
 - establish relationship with regulators so that they will work with us to reach a satisfactory rate level.
- Pricing risk – there’s a longer lag between experience period on which rates are based and effective date.
Mitigation Strategy:
 - establish process to file every quarter if necessary assuring that rate increases remain up-to-date,
 - pay claims timely to reduce reserves and uncertainty in claim projections, making it easier to justify rate needs

- (e) Recommend whether or not AHA should acquire Active Choice based solely on your analysis above in parts (a) through (d). Justify your recommendation.

Commentary on Question:

The position taken, for or against, does not determine the amount of credit awarded. Full credit can be achieved by taking either position. The credit awarded is determined by how well the position is supported based on the analysis of the MLR rebate, risk corridor payment, ACA risks and risk mitigation strategies discussed above. Either argument should address the potential problems and risks discussed above. The “Pro” side will argue that the mitigation strategies are adequate. The “Con” will argue that the mitigation strategies are inadequate.

7. Continued

Candidates also struggled with this section. In general, the support given for the recommendation did not draw on the previous sections of the question, as required.

The suggested answer below is an example of one that could have received full credit.

Active Choice (AC) has clearly cross-subsidized its large and small group businesses. That strategy is not viable in a post-ACA environment. Some of the subsidization lost is mitigated by the ACA's Risk Corridor feature. By its design, the ACA Risk Corridor will never fully subsidize the small group business.

The net effect of being unable to cross-subsidize large and small group is probably manageable through a variety of mitigation strategies, such as those mentioned in part (d) including:

- Introducing new management reporting
- Putting AC on the AHA Health Insurance Company's (AHA) administrative platform.
- Filing AC rates going forward with additional margin.

As noted in part (c), the ACA, introduces risks that go far beyond large and small group subsidization. For example,

- Exchanges introduce the risks of 1) too much business (a "run-on-the-bank") that could incur solvency-threatening costs if underpriced and 2) too little business so that we are unable to recoup our investment.
- The need for URAC and NCQA accreditation.
- Rate filing regulatory hurdles.

Individually, these risks are all manageable and do not present insurmountable hurdles to merging. Collectively, they present too much risk to AHA's operational success. Therefore, I recommend AHA not proceed with the proposed acquisition of AC.

8. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.

Learning Outcomes:

- (1c) Identify and analyze risks faced by an entity, including but not limited to market risk, currency risk, credit risk, spread risk, liquidity risk, interest rate risk, equity risk, hazard/insurance risk, inflationary risk, environmental risk, pricing risk, product risk, operational risk.

Sources:

ERM-512-13: Economics and Financing, Getzen

ERM-504-12: Mapping of Health Company Risks

ERM-501-12: Risk Based Capital – General Overview

Commentary on Question:

Commentary listed underneath question component.

Solution:

- (a) Explain how providers are paid under the following network contracting arrangements:
 - Discounted fee-for-service
 - Contractual fee payments
 - Withholding
 - Capitation
 - Staff model

Commentary on Question:

Many candidates answered this part adequately, although some of the answers were not specific enough to earn full credit. For example, a common response was that contractual fee payments are payments made according to a contract between the provider and insurer. This is generally true for all arrangements. Complete answers should explain the unique, distinguishing features of each specific arrangement.

Discounted fee-for-service

Providers are paid a fixed percentage of their billed charges for the approved services they render to covered members.

8. Continued

Contractual Fee Payments

Providers are paid an agreed-upon price for services rendered to covered members. The reimbursement amount is often based on a DRG, per diem, or fixed fee schedule.

Withholding

The provider is paid a fixed percentage of an agreed-upon fee schedule upon rendering services. The remainder goes into a withhold pool. At the beginning of the year, the insurer projects the total cost for services subject to withholding. If the actual costs exceed the projected costs, the insurer deducts the difference from the withhold pool up to the total amount in the pool. Providers receive the balance, if any, of the withhold pool at the end of the year.

Capitation

Providers are paid a fixed amount (e.g. PMPM or percent of premium) for each member assigned to their care.

Staff Model

Providers are employed directly by the insurer and are paid a salary. This arrangement is similar to a closed panel HMO (CPHG).

- (b) Lyon Corporation's new CRO is concerned about how provider contracting approaches influence AHA's exposure to the following risks:
- Reserve Adequacy
 - Provider Financial Viability
 - Trend
 - Required Capital increase
- (i) Define each of these risks.
- (ii) Explain how each of the last four network contracting arrangements in (a) could alter a company's exposures to these risks as compared to Discounted fee-for-service.

Commentary on Question:

Subpart (i) was done reasonably well. A common mistake on subpart (ii) was discussing the relative size of the reserve as opposed to the uncertainty of its adequacy. Similarly, several candidates compared the relative magnitude of trend, rather than its relative uncertainty under each arrangement. The justification to each answer is important, and in some cases a variety of answers could receive full credit provided the justification is satisfactory.

8. Continued

Candidates could address the fourth risk, Required Capital increase, either by considering the effect on RBC or by more generally considering how the differences in arrangements would affect variance (i.e., risk) and, therefore, the amount of capital a company would need to hold. The answers in the model solution include both types of responses. The RBC responses make reference to specific managed care credit percentages – candidates were not expected to know the specific percentages and could receive full credit for that item merely by noting that there is a managed care credit.

(i)

- Reserve adequacy – The risk that reserves are (i) too low and cannot support their underlying liabilities; or (ii) excessive which can have negative implications for pricing.
- Provider financial viability – The risk that a provider is unable to meet its obligations under a network contract.
- Trend – Trend is greater than anticipated because (i) the unit cost of goods is greater than anticipated; (ii) the mix of services is different than anticipated; or (iii) utilization of services is higher than anticipated.
- Required capital increase – The risk that risk based capital (RBC) requirements increase. RBC increases could threaten a company’s ability to continue operations with its available assets, or reduce its asset return.

(ii)

Provider Contracting Approach	Risk	Compared to Discounted FFS	
		How Risk Changes	Why Risk Changes
Contractual Fee Payments	Reserve Adequacy	Lower	There will be less volatility in payment amounts because unit prices are stated in the contract.
	Provider Financial Viability	Unknown	Providers may benefit from a stronger network and so have lower risk. Alternatively, increasing billed charges will not impact reimbursement. Either way, the effect on this risk is likely to be small.
	Trend	Lower	Catastrophic payments are less likely; therefore, trend is likely to be more stable.

8. Continued

	Required Capital Increase	Lower	Required capital needed should be lowered because one potential source of unfavorable variance, unit prices, is fixed. RBC would be reduced due to a 15% managed care credit.
Withholding	Reserve Adequacy	Lower	Adverse experience would be offset by the withhold pool, mitigating some unexpected insurer losses.
	Provider Financial Viability	Greater	A delay in the full payment could result in liquidity problems for some providers. Providers who do not receive the full withhold pool could also suffer financially.
	Trend	Lower	Unexpectedly high trends would be mitigated by the withhold pool.
	Required Capital Increase	Lower	Required capital needed should be lowered because withhold will mitigate unfavorable cost variances. RBC would be reduced due to a managed care credit of up to 25%.
Capitation	Reserve Adequacy	Much lower	Capitation amounts are known, so the reserves are easily quantified.
	Provider Financial Viability	Greater	Risk of exposure to an unhealthier population is transferred to the provider.
	Trend	Much lower	Capitation amounts are known, so trends are easier to determine.
	Required Capital Increase	Much lower	If capitation is widely used, required capital needed should be lower because capitation eliminates potential sources of unfavorable cost variances. RBC would be reduced due to a 60% managed care credit.
Staff Model	Reserve Adequacy	Much lower	Reserves only needed for out-of-network (if covered) or out-of-area benefits, so there is limited exposure to inadequate reserves
	Provider Financial Viability	Lower	The insurer directly employs providers, so there is virtually no provider financial viability risk (to the extent that the insurer remains solvent).

8. Continued

	Trend	Lower	Providers are paid a salary by the insurer, so there is limited exposure to unexpected changes in trend.
	Required Capital Increase	Much Lower	Required capital needed should be much lower because staff eliminates most potential for unfavorable cost variances. RBC would be reduced due to a 75% managed care credit.