
SOCIETY OF ACTUARIES
Enterprise Risk Management – Group Health Extension

Exam ERM-GH

Date: Tuesday, October 29, 2013

Time: 8:30 a.m. – 12:45 p.m.

INSTRUCTIONS TO CANDIDATES

General Instructions

1. This examination has a total of 80 points.

This exam consists of 8 questions, numbered 1 through 8.

The points for each question are indicated at the beginning of the question. Questions 7 and 8 pertain to the Case Study, which is enclosed inside the front cover of this exam booklet.
2. Failure to stop writing after time is called will result in the disqualification of your answers or further disciplinary action.
3. While every attempt is made to avoid defective questions, sometimes they do occur. If you believe a question is defective, the supervisor or proctor cannot give you any guidance beyond the instructions on the exam booklet.

Written-Answer Instructions

1. Write your candidate number at the top of each sheet. Your name must not appear.
2. Write on only one side of a sheet. Start each question on a fresh sheet. On each sheet, write the number of the question that you are answering. Do not answer more than one question on a single sheet.
3. The answer should be confined to the question as set.
4. When you are asked to calculate, show all your work including any applicable formulas.
5. When you finish, insert all your written-answer sheets into the Essay Answer Envelope. Be sure to hand in all your answer sheets since they cannot be accepted later. Seal the envelope and write your candidate number in the space provided on the outside of the envelope. Check the appropriate box to indicate Exam ERM-GH.
6. Be sure your written-answer envelope is signed because if it is not, your examination will not be graded.

Tournez le cahier d'examen pour la version française.

CASE STUDY INSTRUCTIONS

The case study will be used as a basis for some examination questions. Be sure to answer the question asked by referring to the case study. For example, when asked for advantages of a particular plan design to a company referenced in the case study, your response should be limited to that company. Other advantages should not be listed, as they are extraneous to the question and will result in no additional credit. Further, if they conflict with the applicable advantages, no credit will be given.

****BEGINNING OF EXAMINATION****

- 1.** (8 points) Blackhawk Life is a mid-size U.S. insurer that writes both deferred variable annuities with investment performance guarantees and deferred fixed annuities. The assets backing the fixed annuities are largely invested in U.S. Treasuries and corporate bonds. The variable annuity guarantees are dynamically hedged using a combination of equity options, equity futures, and interest rate swaps.

Blackhawk currently has a stress testing program that runs historical scenarios simulating major market crises that have occurred. Blackhawk is considering performing sensitivity tests as well.

- (a) (1 point) Evaluate the advantages of analyzing stress test results for the fixed and variable blocks separately versus in aggregate.
- (b) (2 points) Recommend four key unidimensional sensitivity tests that Blackhawk should run to analyze the risks of its business. Justify your response.
- (c) (3 points) 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.
- (d) (2 points) 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).

2. (11 points) Consider a portfolio comprised of two stocks, XYZ and ABC. Each stock price follows geometric Brownian motion with parameters:

Stock	Mean Annual Return (μ)	Annual Volatility (σ)	Market Value (S_0)
XYZ	5%	15%	100
ABC	10%	20%	150

These two stocks are assumed to be uncorrelated during normal market conditions; however, when the market is performing poorly the stocks are positively correlated.

The variables n_1 and n_2 are independent and randomly simulated standard normal variables used to simulate the annual returns of holding companies XYZ and ABC, respectively.

The tail dependency of the returns is reflected as follows:

- When $n_1 \leq -1.96$, the correlation coefficient $\rho = 0.8$
- When $n_1 > -1.96$, the correlation coefficient $\rho = 0$

You have generated 21 simulations and ordered (highest portfolio value to lowest) the simulated values as follows:

Table 1: Ordered Simulations

Simulation	n_1	n_2
1	0.64	1.29
2	0.94	1.11
3	1.15	0.88
...
19	-1.12	-1.05
20	-1.65	-0.95
21	-2.71	-0.75

You are given:

$$S_t = S_0 e^{\left(\mu - \frac{\sigma^2}{2}\right)t + \varepsilon\sigma\sqrt{t}}$$

2. Continued

- (a) (1.5 points) 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.
- (b) (3 points) Determine the one year VaR(95%) for the portfolio value. Show your work.
- (c) (2 points) 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 $n_1 \leq -1.96$
- (d) (3 points) Explain the steps required to determine VaR(95%) for the portfolio value using the antithetic variable reduction technique.
- (e) (1.5 points) Describe two additional variance reduction techniques and evaluate whether each is appropriate to use when modeling correlated equities.

3. (12 points) You are a risk management consultant and have been hired by Wrigley Financial to assist in the selection of a risk measure for Wrigley to use in its economic capital calculations. You are considering the following risk measures:

- $\rho_1(X) = 95^{\text{th}}$ percentile of X
- $\rho_2(X) = E[X | X > \rho_1(X)]$
- $\rho_3(X) = \frac{1}{\alpha} \log E[e^{\alpha X}]$, for $0 < \alpha$

Where X represents a loss random variable.

- (a) (4 points) 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
- (b) (3 points) 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 - $\rho_2(X)$
- (c) (4 points) Determine which of the criteria in (a) are satisfied by $\rho_3(X)$. Show your work.
- (d) (1 point) Recommend a risk measure for Wrigley to use in its economic capital calculations, from the three proposed. Justify your answer.

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4. (11 points) You are the marketing actuary for Hamsik Re. E&J Life Insurance Company is a client of Hamsik for traditional reinsurance but has not used financial reinsurance in the past.

E&J has an inforce block of traditional whole life policies issued between 1978 and 1984, having \$2 billion in face amount and \$512 million in statutory reserves (the “whole life block”). The assets backing this whole life block are duration matched to the liabilities and have an average maturity of 11 years. E&J manages the mortality risk on this block using YRT reinsurance.

Hamsik and E&J are contemplating entering into a reinsurance agreement effective January 1, 2014. Under this agreement Hamsik would assume the whole life block on a coinsurance with funds withheld basis.

The following projections are provided for the whole life block:

Cash Flows and Inventory Items for the Whole Life Block Including YRT Reinsurance But Prior to Coinsurance with Funds Withheld Reinsurance
(in USD Millions)

Year	Premium (Net of YRT Premium)	Investment Income	Benefits	Increase in Statutory Reserve	Dividends*	Pre-tax Income	End of Year Statutory Reserves	Gross Face Amount	YRT Reinsured Face Amount
2014	50	31	23	(1)	20	39	511	1,968	1,669
2015	49	31	23	(2)	20	37	509	1,869	1,576
2016	47	31	23	(2)	20	36	507	1,776	1,499
2017	46	30	23	(2)	20	35	505	1,687	1,428
2018	44	30	23	(3)	20	34	502	1,603	1,348
2019	43	30	23	(3)	20	33	499	1,523	1,283
2020	42	30	22	(3)	20	32	496	1,446	1,223
2021	40	30	22	(3)	20	31	493	1,374	1,167
2022	39	30	22	(4)	20	30	489	1,305	1,106
2023	38	29	22	(4)	20	29	486	1,240	1,041

* Dividends are paid annually and serve to return to the policyholders a portion of any positive variance in mortality or investment experience.

Under the proposed agreement, Hamsik would assess an annual risk charge of 100 basis points of reinsured reserves. This charge is scheduled to increase to 500 basis points on January 1, 2019, at which point it is assumed E&J will exercise its recapture rights as allowed for under the terms of the agreement.

Both Hamsik and E&J are domiciled in the same regulatory jurisdiction.

4. Continued

- (a) (1 point) Provide arguments supporting the contention that the proposed agreement qualifies as a financial reinsurance transaction.
- (b) (1 point) Identify the characteristics of the whole life block that make it a good candidate for a financial reinsurance transaction.
- (c) (1 point) Identify and explain two benefits, one statutory and one economic, to E&J of entering into this transaction.
- (d) (1 point) 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.
- (e) (4 points) 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)
- (f) (2 points) 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.

- (g) (1 point) 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.

5. (8 points) Millennium Life is a publically traded U.S. life insurance company that has performed consistently since its inception in 1913. Millennium set up an ERM department in 2003 and developed the following Risk Appetite Statement (RAS) at that time:

- I. Excess Capital (measured on a statutory basis) shall not decrease by more than 20% in a 1 in 200 year event.
- II. Return on statutory capital (ROC) shall not fall below 5% per annum in any year.
- III. S&P financial strength rating shall not decrease below current AA level.

Millennium applies components I and II of this RAS to each line of business (LOB) to ensure that Millennium meets these goals in aggregate. For this purpose, all investable assets are allocated to the lines of business.

- (a) (1 point) Define Risk Appetite.
- (b) (2 points) Explain the rationale for including each of the metrics in Millenium's RAS and how they individually and collectively affect business decisions.
- (c) (2 points) Explain how the following stakeholders may view the existing RAS:
 - (i) Millennium's Pricing Department
 - (ii) Regulators
 - (iii) Shareholders
 - (iv) Debt Holders
- (d) (1 point) Explain the implications of Millennium's approach to managing to its RAS by LOB.
- (e) (2 points) 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.

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- 6.** (10 points) Dearbourne Corporation is an innovative electronics corporation, bringing customers the latest in today's best computerized gadgets. Dearbourne has suffered losses recently due to both operational failures and emerging competition.

Dearbourne has only two divisions:

Division A: Manufacturing and quality control of product

Division B: Research and Development of new electronic technologies

- (a) (2 points) 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.

Dearbourne is in the process of completing its next manager operational risk survey. These surveys are completed by individually interviewing selected managers.

- (b) (1.5 points) Outline the objectives you intend to achieve in conducting these surveys.

- (c) (3 points) 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

Dearbourne thinks environmental scanning would help identify emerging competitive risks and opportunities. One evolving issue Dearbourne is monitoring is the emergence of wearable technology (clothing and accessories incorporating computer and other electronic technologies).

- (d) (2.5 points)
 - (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.
- (e) (1 point) Explain how undirected viewing of the current technology environment could help identify Dearbourne's competitive risks.

Questions 7 – 8 pertain to the Case Study.
Each question should be answered independently.

7. (13 points) The President of AHA has asked you to evaluate the proposed acquisition of Active Choice. The state of New York already requires community rating in the small group market, so he believes the impact of the Affordable Care Act (ACA) will not be particularly dramatic for Active Choice.

(a) (2 points) The Active Choice income statements that have been provided for AHA’s review are prior to minimum loss ratio rebates. In order to estimate the effect of the rebates, you make the following simplifying assumptions:

- Ignore the deduction from earned premium for federal income tax on underwriting gain allowed in the rebate calculation.
- Assume Insurance Taxes, Licenses and Fees are the same percentage of premium in all states and all markets when calculating the allowed deduction from earned premium.
- Activities to improve the quality of care are included in the incurred claims.
- Use the following credibility table

Life Years	Base Credibility Factor
<1,000	No Credibility
1,000	8.3%
2,500	5.2%
5,000	3.7%
10,000	2.6%
25,000	1.6%
50,000	1.2%
≥75,000	0.0% (Full Credibility)

Calculate the large group and small group minimum loss ratio rebate for Active Choice.

Questions 7 – 8 pertain to the Case Study.
Each question should be answered independently.

7. Continued

- (b) (1 point) You make the following assumptions about Active Choice's small group expenses:
- Total administration expense and profit in the small group market is 20% of premium.
 - Insurance Taxes, Licenses & Fees is the same percentage of premium in the small and large group markets.

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

- (c) (4 points) 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.
- (d) (4 points) 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.
- (e) (2 points) Recommend whether or not AHA should acquire Active Choice based solely on your analysis above in parts (a) through (d). Justify your recommendation.

Questions 7 – 8 pertain to the Case Study.
Each question should be answered independently.

- 8.** (7 points) You have been asked to prepare a report explaining how AHA's and Active Choice's different approaches to network contracting influence the risks each company faces.
- (a) (2 points) Explain how providers are paid under the following network contracting arrangements:
- Discounted fee-for-service
 - Contractual fee payments
 - Withholding
 - Capitation
 - Staff model
- (b) (5 points) 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.

****END OF EXAMINATION****

USE THIS PAGE FOR YOUR SCRATCH WORK

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