

# ERM-ILA Model Solutions

## Spring 2014

### 1. Learning Objectives:

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:

- (3a) Apply and construct risk metrics to quantify major types of risk exposure such as market risk, credit risk, liquidity risk, regulatory risk, etc., and tolerances in the context of an integrated risk management process.
- (3b) Analyze and evaluate the properties of risk measures (e.g. Delta, volatility, duration, VaR, TVaR, etc.) and their limitations.
- (3c) Analyze quantitative financial data and construct measures from insurance data using modern statistical methods (including asset prices, credit spreads and defaults, interest rates, incidence, causes and losses). Contrast the available range of methods with respect to scope, coverage and application.

### Sources:

ERM-102-12: Value-at-Risk: Evolution, Deficiencies and Alternatives

Value-at-Risk: The New Benchmark for Managing Financial Risk, Jorion, 3<sup>rd</sup> Edition

- Ch. 5, Computing VaR
- Ch. 19, Operational Risk Management

ASOP 23: Data Quality

### Commentary on Question:

*In answering this question, candidates are expected to analyze and evaluate the applications of risk measures to operational risk and to recognize their limitations. Candidates should also demonstrate a good understanding of the challenges in dealing with high-severity / low-frequency risks.*

### Solution:

- (a) Identify which shortcomings of VaR affect its use when determining EC for operational risk. Explain your answer.

## 1. Continued

### **Commentary on Question:**

*From ERM 102-12, there are 6 shortcomings of VaR given, but not all shortcomings are specific to this situation. The three shortcomings discussed in the response below are considered the most relevant. Candidates who discussed other shortcomings, either from the list of six or from other sources, could receive some credit, if the answer was explained well and relevant to the question asked. Most candidates did reasonably well on this part.*

Coherency, subadditivity, and tail risk – If op risks occur, they are low frequency but high severity events, which are not captured well with VaR; VaR does not reflect the magnitude of these extreme losses because it's a threshold value, a point estimate.

Normal distribution – With op risk, we are interested in both high frequency/low severity and low frequency/high severity losses; a normal distribution may not appropriately capture the low frequency/high severity events.

Data and observation period – Assumes the past can predict the future. A shorter period of data may allow quick adaptation to current events, while a longer period of data can capture more varied markets and more extreme events. In this case, the Bank's past experience with this risk may be irrelevant, as new controls have been put into place, which would presumably affect outcomes. In addition, obtaining the data may be very difficult, and will rely on the Bank's abilities to collect this data internally or to access external sources of data.

- (b) You are tasked with assessing whether the data used for these EC calculations is compliant with ASOP 23. List three considerations the team should apply from the ASOP when selecting data. Explain the challenges involved in calculating EC for operational risk with the current data

### **Commentary on Question:**

*The candidates in majority did well on part (i) and received some credit in part (ii). Higher scores are given to candidates who provided thorough and well-rounded explanations for the challenges Bayou faces.*

*As the question was testing knowledge of the ASOP, candidates did not receive credit in (i) for general considerations if not part of the ASOP. The answers shown below for (ii) are more complete than would be expected on the exam. Three relevant, well-explained challenges would be sufficient for full credit.*

## 1. Continued

- (i) List three considerations the team should apply from the ASOP when selecting data.

Any three of the following:

1. Appropriateness of the data
2. Reasonableness and comprehensiveness of the data elements
3. Known, material limitations of the data
4. Cost and feasibility of obtaining alternative data
5. Benefits vs. time and cost of alternative data
6. Sampling methods used

- (ii) Explain the challenges involved in calculating EC for operational risk with the current data.

1. The appropriate frequency of observations for the VaR calculation needs to be determined, e.g. monthly, quarterly, or annual, etc. It depends on the number of internal events that the Bank has that can be qualified as relevant data for op risk. Considerations also need to be given as to the number of competitors to be included in the survey data and the time period to be covered by the survey data.

2. Determination needs to be made on the use of the internal data from occurrences prior to the internal control changes, i.e., should any of the older data also be included? To keep a good mix of internal data and survey data, the answer might also depend on how current the collectible survey data is.

3. A fundamental consideration for using historical data prior to the internal control changes is to understand if the changes to the internal controls made the data on prior internal events not applicable. These events might not have been measured and recorded consistently over time. Similarly, considerations need to be given on the appropriateness of the survey data for the firm as the surveyed competitors might not have similar internal controls.

4. Furthermore, the Bank's records on the internal events might not be complete. It's possible that qualified internal events might not have been recorded prior to the full institution of the new internal controls. On the other hand, competitors might not be willing to report all events or include all data in the survey.

- (c) Explain how estimation error affects how these estimates of VaR are interpreted.

## 1. Continued

### **Commentary on Question:**

*This question tests candidates' ability to make sound judgment about the VaR results.*

- Providing a confidence band with the VaR estimate conveys more information than the VaR estimate alone.
  - A VaR with a smaller confidence band is more precise than one with a larger confidence band.
  - Both of these statistics are attempting to measure the same thing, but the first is providing far less information, as the 95% confidence band covers \$160 - \$260 million, while the second band is much tighter, covering only \$240 - \$260 million. The estimation error makes the first measure less reliable than the second.
- (d) The team uses the quantile approach to calculate the estimation error in the operational risk component of VaR.
- (i) Explain an alternative approach for calculating the estimation error.
  - (ii) Explain the advantages and disadvantages of these two approaches.
  - (iii) Recommend to the CRO whether the alternative approach should be used instead of the quantile approach. Justify your response.

### **Commentary on Question:**

*The intended response to (i) was the parametric approach, as shown in the response below. The grading took account of the fact that candidates suggested a wide variety of approaches that could be alternatives to the quantile approach. Credit was given to candidates who discussed the parametric approach in general, or chose a specific type of the parametric approach as their selection, or used a variation of a nonparametric approach in their answers. Therefore, a good answer could be quite different from the model solution. However, candidates needed to demonstrate a good level of knowledge in their choices and reasoning to receive good scores.*

*Similarly, although the quantile approach is the preferred answer for part (iii) in the model solution, credit was given for other recommendations that were supported by good explanations.*

- (i) Parametric Approach – When the underlying distribution is known, we can determine the distributions of the estimated mean and variance. We can use these results to construct confidence bands for the point estimates.

## 1. Continued

In these cases, as the sample size increases, the precision of the estimate also increases.

(ii) Parametric Approach

- Pro: Inherently more precise than quantile approach as the sample standard deviation contains more information than the sample quantile.
- Con: May be difficult to determine the proper distribution in order to apply this method.

Quantile Approach [Non-parametric]

- Pro: Standard error can be estimated by bootstrapping the data when the underlying distribution is unknown.
- Con: Has substantial estimation errors relative to parametric approach (i.e. much larger confidence bands), especially for high confidence levels / rare events.

(iii) The parametric approach is inherently more precise than the quantile approach (the sample standard deviation contains more information than the sample quantile), but it can be difficult to determine the proper distribution in order to apply this method.

The quantile approach allows the standard error to be estimated without making an assumption about the underlying distribution. Since we cannot be sure what the underlying distribution is in this case, the quantile approach is more appropriate. However, it will give large estimation errors, which produces an imprecise range.

## 2. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

### Learning Outcomes:

- (2d) Apply and analyze scenario and stress testing in the risk measurement process.
- (2e) Evaluate the theory and applications of extreme value theory in the measuring and modeling of risk.
- (2f) Analyze the importance of tails of distributions, tail correlations, and low frequency/high severity events.

### Sources:

Value-at-Risk: The New Benchmark for Managing Financial Risk, Jorion, 3rd Edition

- Ch. 14 Stress Testing
- Ch. 5 Computing VaR

Modeling Tail Behaviour with Extreme Value Theory, Risk Management, Sept 2009

Financial Enterprise Risk Management, Sweeting, 2011, Ch. 12 Extreme Value Theory

### Commentary on Question:

*This question was designed to test the candidate's understanding of Extreme Value Theory (EVT) concepts and the strengths, weaknesses and limitations of EVT models. Candidates were also expected to be able to apply EVT to a specific situation.*

### Solution:

- (a) Define Extreme Value Theory (EVT) and explain its purpose in statistics and modeling.

### Commentary on Question:

*Candidates did well on this portion of the question and showed a good understanding of EVT and its focus on creating a distribution of tail events that is separate from the rest of the underlying distribution.*

EVT is a technique used to model the distribution of tail risks above a certain threshold, using historical data to infer information about the tail.

EVT is used to model low frequency / high severity events, or 'black swan' events, where other distributions typically do not adequately capture the risk in the tails.

## 2. Continued

- (b) You have been asked to recommend a threshold level based on the table above in order to fit an EVT distribution.
- (i) Explain the tradeoffs, in general, of choosing among the possible threshold levels.
  - (ii) Recommend a threshold level for Biersch. Justify your choice.

**Commentary on Question:**

*Candidates did well on this portion of the question and understood the balancing act between choosing a threshold that is too high, which limits data points used to calibrate parameters, and choosing one that is too low which potentially leads to including non-tail events. Note that the actual recommendation of a specific threshold was secondary to the explanation of the thought process followed by the candidate.*

- (i) Choosing a threshold level is a balancing act. Choosing a threshold that is too high will ensure you are focusing on extreme events, but it will limit the amount of data available to calibrate the model, which will potentially increase parameter estimation error. Choosing a threshold that is too low will increase the amount of data available to calibrate the model, but it may include data points which are not truly extreme and therefore are not appropriate to include in the EVT analysis.
  - (ii) I recommend using a threshold of \$910 million, as the scale and shape parameters stabilize at this point. While they are also stable at higher thresholds, \$910 million allows for more data points available to calibrate the model.
- (c)
- (i) Demonstrate that the CRO's calculation of the 16% probability is correct based on the selection of the \$910 million threshold. Show your calculations.
  - (ii) Explain whether or not the 16% probability that losses will exceed \$1 billion at least once over the next 30 years is reasonable.
  - (iii) Explain the limitations of the current modeling framework, assumptions and data.

**Commentary on Question:**

*The purpose of this question was to allow candidates to demonstrate their familiarity with EVT and use of the GPD. Candidates struggled with c(i) and c(ii), perhaps because the specific formula for the GPD was not provided.*

## 2. Continued

*However, there were several ways to analyze the reasonableness of the CRO's 16% probability and grading points were generally awarded for responses which provided a clear explanation and supporting logic, rather than requiring a specific response.*

*Candidates did well on c(iii) and showed a general understanding of the limitations of the EVT modeling framework, the underlying data used for EVT and the challenges of applying EVT in a real world setting.*

- (i) The CRO's calculation was derived using the following approach.

$$\begin{aligned}G(x) &= 1 - (1 + x/\beta\gamma)^{-\gamma} \quad \text{if } \gamma \neq 0; \\1 - G(x) &= 1 - (1 - (1 - .91)/(.03*10))^{-10} = 0.07254 \\1 \text{ Year Unconditional Prob } (\geq 1 \text{ bil}) &= \text{Percentile} * (1 - G(x)) \\&= 0.08 * 0.07254 = 0.0058 \\30 \text{ Year Prob } (\geq 1 \text{ bil}) &= 1 - (1 - 0.0058)^{30} = 0.16021\end{aligned}$$

*While the 16% can be reconciled using the formulation provided above, there are alternate responses that could have been arrived at which did not reconcile to the 16%, either due to using different units (e.g., millions) for the loss amounts or due to using a different approach. Grading points were awarded for demonstrating familiarity with the GPD and use of the associated parameters regardless of whether the 16% result was obtained.*

- (ii) The historical probability of an annual loss greater than \$910m is 8% based on the model data in the table, so the probability of a loss greater than \$1 billion can be estimated to be lower than 8% (perhaps 6%). The 16% probability quoted by the CRO is unreasonable vs. the 6% - 8% because the P(loss > 1 billion) are on two different time periods, the 16% being over a 30 year period versus the table showing an 8% probability of a loss exceeding \$910M in any given year.

$$\begin{aligned}&P[\text{annual loss} > \$910 \text{ million in a given year}] \\&= 1 - P[\text{annual loss does not exceed } \$910 \text{ million in a given year}] \\&= 1 - 0.08 = 92\% \\&\text{Then, assuming independence,} \\&P[\text{Annual loss does not exceed } \$910\text{M in each of 30 years}] = 1 - 92\%^{30} = \\&91.8\% \\&\text{Therefore the 16\% probability appears to be understated based on the historical data.}\end{aligned}$$



## 2. Continued

(iii)

- The amount of data used to calibrate the EVT distribution is limited
- The selection of the threshold is subjective but it impacts the results
- Historical data may not be indicative of future events
- Model assumes all events are independent and identically distributed which may not hold true and ignores any potential correlations in the risk
- The data has been adjusted to fit company exposure and this adjustment process may impact the analysis

(d) Propose additional analyses to supplement the EVT analysis performed above.

**Commentary on Question:**

*Candidates performed well on (d) and provided a variety of quantitative and qualitative methods to supplement the EVT analysis.*

EVT should be supplemented with sensitivity testing and scenario analysis which would provide additional insights into the potential exposures that may not be included in the historical data or the EVT model calibration.

In addition, expanding the data set to include other relevant industry data may improve the model, and running stochastic simulations may provide other insights into the risk.

### 3. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

#### Learning Outcomes:

- (2b) Evaluate how risks are correlated, and give examples of risks that are positively correlated and risks that are negatively correlated.
- (2c) Analyze and evaluate risk aggregation techniques, including use of correlation, integrated risk distributions and copulas.
- (2g) Analyze and evaluate model and parameter risk.
- (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.

#### Sources:

ERM-101-12: Measurement and Modeling of Dependencies in Economic Capital

ERM-103-12: Basel Committee – Developments in Modeling Risk Aggregation

Value-at-Risk, The New Benchmark for Managing Financial Risk, Jorion, 3rd Edition, Ch. 5 Computing VaR

#### Commentary on Question:

*In general, candidates performed well on this question, demonstrating adequate knowledge of various risk aggregation techniques and concepts. The last part of the question is designed to be challenging, yet many candidates seemed to be well versed in the concept of tail dependency and mathematical derivation.*

#### Solution:

- (a) Explain why the risks for these two LOB's may not perfectly offset each other.

#### Commentary on Question:

*The following list is more comprehensive than what is required for full credit. Most candidates were able to recognize the difference in underlying risk exposure as the main reason.*

- Underlying distribution of insured lives may differ in significant ways, e.g., attained age, gender mix, socio-economic and demographic composition, etc. Mortality risk is typically underwritten whereas longevity risk is typically not.

### 3. Continued

- Even if the insured lives are highly correlated, the size of the two portfolios appears to be different (at least as measured by expected cash outflows)
- Benefit provisions and contractual terms may limit the mortality/longevity risk exposure which may result in imperfect offsetting of risks.
- Catastrophe event usually impacts mortality, but less so longevity.

- (b) Calculate the EC for the combined LOBs using the fixed diversification percentage method. Show your work.

**Commentary on Question:**

*While many candidates correctly applied the VaR formula and diversification method, some candidates failed to recognize the standard deviation given in the question is an absolute dollar amount, not a percentage, and thus erroneously included the [net expected cash outflow] as an extra multiplicative component.*

$$\text{VaR}(\text{LOB A}) = 20 \text{ million} \times 2.576 = 51.52 \text{ million}$$

$$\text{VaR}(\text{LOB B}) = 16 \text{ million} \times 2.576 = 41.216 \text{ million}$$

$$\text{Total EC} = (51.52 + 41.216) \times (1 - 0.4) = 55.6416 \text{ million}$$

- (c) Calculate the correlation for mortality/longevity risk between LOBs from the simulation runs. Show your work.

**Commentary on Question:**

*Most candidates recalled the formula and applied it perfectly.*

Recall the Pearson correlation coefficient formula:

$$\rho(X, Y) = \text{Cov}[X, Y] / \sqrt{\text{Var}(X) \text{Var}(Y)}$$

$$\begin{aligned} \rho &= (E[\text{ECF}(\text{LOB}_A) \times \text{ECF}(\text{LOB}_B)] - E[\text{ECF}(\text{LOB}_A)] \times E[\text{ECF}(\text{LOB}_B)]) / \\ &(\text{StdDev}(\text{LOB}_A) \times \text{StdDev}(\text{LOB}_B)) \\ &= (11,860 - 100.8 \times 118.8) / (22.3 \times 16.3) = -0.316 \end{aligned}$$

- (d) Recalculate the EC for the combined LOBs based on the variance-covariance method. Show your work.

**Commentary on Question:**

*Many candidates used the matrix approach, but failed to set up the matrix correctly. If the matrix is set up correctly, the result is as shown here. A few candidates erroneously used the correlation factor as the fixed diversification factor.*

### 3. Continued

$$\begin{aligned} EC &= \sqrt{\text{VAR}(\text{LOB}_A)^2 + \text{VAR}(\text{LOB}_B)^2 + 2 \times \rho \times \text{VAR}(\text{LOB}_A) \text{VAR}(\text{LOB}_B)} \\ &= \sqrt{(51.52^2 + 41.216^2 + 2 \times (-0.316) \times 51.52 \times 41.216)} \\ &= 54.87 \end{aligned}$$

- (e)
- (i) Explain what the CRO means by his statement above.
  - (ii) Estimate  $\theta$  using the values provided in the table above. Show your work.
  - (iii) Explain whether or not the Clayton copula is appropriate in this circumstance.

#### **Commentary on Question:**

*In (i) many candidates struggled to articulate the concept. While many candidates did recognize that the simple correlation factor cannot reflect the complex relationship, they failed to explain the shortcomings.*

*The application of the Clayton copula was the most challenging part of the question, as the source material does not directly illustrate application of copulas. Some candidates successfully derived the dependency formula, but few were able to use the tabulated values to estimate the parameter. Candidates received partial credit for demonstrating reasonable approaches to the problem.*

*Most of the answers in (iii) were simplistic without much “explanation” provided. The question was testing whether candidates understood the concepts of tail dependence as well as the practicalities of using copulas.*

- (i)
  - Correlation is simply a scalar measure of dependency. It cannot tell everything about the dependency structure of risks. In another words, correlation reduces the relationship to a single variable which may not effectively capture the nuance of this relationship.
  - Correlation may not be static overtime
  - Simulation runs may not produce the true correlation between two LOBs
  - Correlation may not be an appropriate dependency measure for tail risk. EC is a measure of tail risk at VaR 99.5% in this case.
  - There may be a different level of dependence for the same cohorts of business depending on the nature of the scenario being considered and the point in time being considered.

### 3. Continued

- Correlation is not invariant under monotonic transformation

(ii) The coefficient of lower tail dependence for the copula is defined to be:

$$\lim_{v \rightarrow 0} \frac{C(v, v)}{v}$$

For Clayton Copula:

$$\begin{aligned} \text{Tail Dependency} &= \lim_{x \rightarrow 0} \frac{C(x, x)}{x} = \lim_{x \rightarrow 0} \frac{(x^{-\theta} + x^{-\theta} - 1)^{-1/\theta}}{x} \\ &= \lim_{x \rightarrow 0} \frac{(2x^{-\theta} - 1)^{-1/\theta}}{x} = \lim_{x \rightarrow 0} \frac{(2x^{-\theta} - 1)^{-1/\theta}}{(x^{-\theta})^{-1/\theta}} = \lim_{x \rightarrow 0} \left[ \frac{2x^{-\theta} - 1}{x^{-\theta}} \right]^{-1/\theta} \\ &= \lim_{x \rightarrow 0} [x^\theta (2x^{-\theta} - 1)]^{-1/\theta} = \lim_{x \rightarrow 0} (2 - x^\theta)^{-1/\theta} = 2^{-1/\theta} \end{aligned}$$

Using Lower tail dependency to estimate the  $\theta$ :

$$2^{(-1/\theta)} = 0.79 \implies (-1/\theta) \ln 2 = \ln(0.79) \quad \theta = 2.94$$

(iii)

- In evaluating the relationship between mortality and longevity, we would expect some level of dependence in the middle of the distribution reflecting that there is some relationship between mortality and longevity
- Heavier dependency would be expected at the tails as extreme events would more likely reduce the relevance of the differences in the underlying lives insured versus lives annuitized
- Clayton copula is relatively difficult to parameterize and simulate, but it is capable of modeling tail dependence.
- However, the copula technique is very abstract and difficult to interpret, thus it has limitations in risk aggregation applications.

#### **4. Learning Objectives:**

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:**

- (4c) Demonstrate means for transferring risk to a third party, and estimate the costs and benefits of doing so.
- (4d) Demonstrate means for reducing risk without transferring it.
- (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.
- (5c) Explain the challenges and limits of economic capital calculations and explain how economic capital may differ from external requirements of rating agencies and regulators.

#### **Sources:**

ERM-114-13: Intro to Reinsurance – Wehrhahn

ERM-115-13: Creating an Understand of Special Purpose Vehicles – PWC

ERM-116-13: Risk Management and the Rating Process for Insurance Companies, AM Best

#### **Commentary on Question:**

*This question was testing candidates' understanding of Special Purpose Vehicles and reinsurance as ways to transfer risks.*

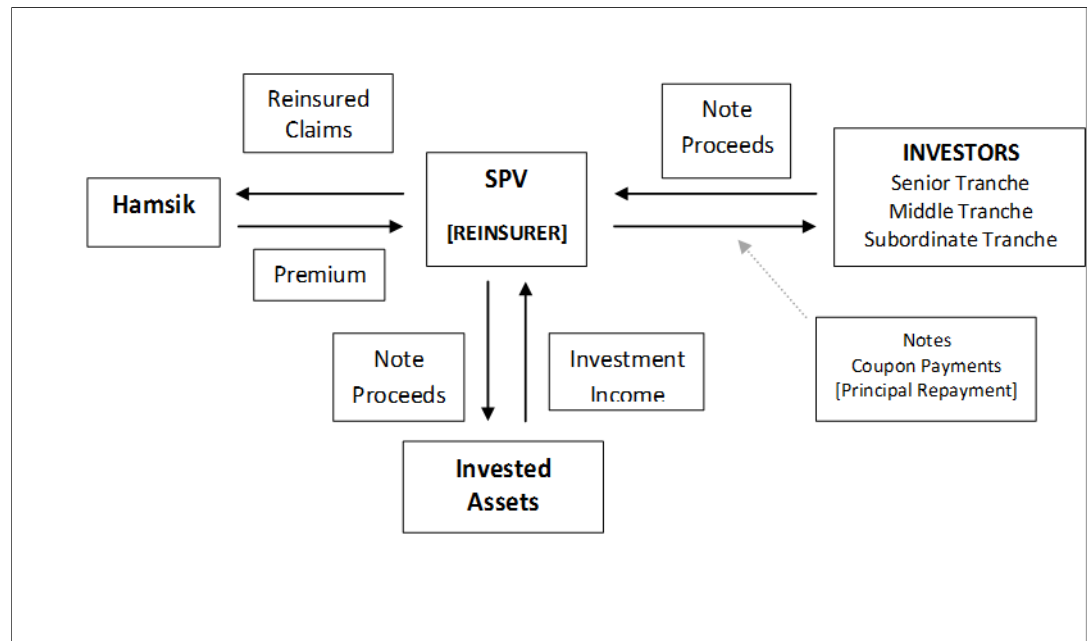
#### **Solution:**

- (a) Draw a diagram that represents a possible structure for Hamsik's SPV. Label all entities and cash flows.

#### **Commentary on Question:**

*Most candidates received partial credit for identifying the key parties involved and for showing that the SPV acted as the intermediary. Candidates lost points for not clearly identifying the cash or asset flows between the parties. Many candidates simply labeled each item "cash flow" without describing what flows would be made.*

## 4. Continued



The diagram above is one example of a possible SPV structure. Other valid structures also received credit.

- (b) Explain key provisions that impact how closely the SPV's coverage matches Hamsik's existing reinsurance agreement.

### **Commentary on Question:**

*Candidates typically did not do well on this part of the question. Most either listed provisions without describing them or discussed only one or two provisions. Four well-explained provisions would be sufficient for full credit.*

**Tranches:** Define which tranche will fund the losses and at which annual loss amounts. This should not impact Hamsik. If the investments are fully funded Hamsik will collect on claims payments and will not have the counterparty risk that the company had under a reinsurance arrangement.

**Length of term:** Is this a one year investment or multiple years? One year is more typical of reinsurance arrangements, but it could be mutually beneficial to be over a longer horizon within the SPV.

## 4. Continued

Interest rate: What is the interest rate of the bond tranches? Are they zero coupon or do they pay out coupons? Introducing this investment to a broader market will generally lead to interest payments that are less than Hamsik's former reinsurance payments.

Issue amount of the bonds: Unlike the reinsurance arrangement, which pays based on Hamsik's losses, in the SPV arrangement if the losses are larger than the cumulative bond issue amount, Hamsik will not be able to recover all of its losses. However, the bonds are paid interest, so there's a balance that Hamsik has to find that sufficiently covers a reasonably likely set of loss scenarios without writing excessive debt.

Definition of what weather events are included: This can be mirrored from the current reinsurance agreement or could be either more specific or more general.

Are the losses indexed to an index or specific to Hamsik: If they are indexed, there could be mismatch risk to Hamsik.

- (c)
- (i) Explain the potential advantages for Hamsik if it sets up an SPV instead of continuing with its reinsurance agreement.
  - (ii) Explain the potential disadvantages for Hamsik if it sets up an SPV instead of continuing with its reinsurance agreement.

### **Commentary on Question:**

*Similar to part (b), the most common reasons why candidates lost points were by providing lists but not explaining them, or by focusing extensively on one or two items. Full credit required explanation of approximately four advantages and four disadvantages, or eight items in total.*

- (i) Greater diversification benefit for outside investors and gives them a new market to invest in, which increases investment demand and could lead to cheaper/more efficient ways to fund than reinsurance

Decreases counterparty credit risk since the SPV does not rely on a payment post crisis. With reinsurance Hamsik would rely on a reinsurer's ability/timeliness of payment.

Agreement could cover multiple years, while reinsurance is typically annually-renewable.



## 4. Continued

The SPV would be bankruptcy remote, which protects investors and Hamsik. If Hamsik encounters financial difficulties, it cannot access the funds in the SPV. If the underlying assets don't perform well, Hamsik is not liable for the shortfall.

Meets regulatory requirements for transferring assets and liabilities off balance sheet. With reinsurance, that may or may not be possible depending on the laws in the jurisdiction.

- (ii) There may be no appetite in the marketplace for this type of security. They could incur the costs to set up the SPV and then be unable to sell the bonds for some reason, for example, particularly bad emerging weather making investors wary of investing in property insurance.

The market could dry up when the catastrophe bonds pay off, leaving Hamsik in search for a different risk transfer method. Hamsik would then have to retain the risk on its balance sheet or attempt to go back into the reinsurance market.

If Hamsik encounters financial difficulties, the funds in the SPV are isolated and can't be accessed by Hamsik.

The SPV and terms to the agreement would dictate when Hamsik could access the funds, which may not cover all situations during which it may need them.

Signaling effect - If the SPV's assets underperform, the market may draw conclusions about the balance sheet of Hamsik.

Regulatory scrutiny- in the past SPVs have been used to skirt requirements, so the regulators may be wary of this change. Hamsik's reputation may suffer if it uses the SPV.

Hamsik would lose any consultative help and insight that the reinsurer provides.

- (d) State whether you expect the SPV to be viewed by A.M. Best as a positive or negative development for Hamsik's capitalization and operating performance. Explain your answer.

## 4. Continued

### **Commentary on Question:**

*Candidates did relatively well on this part of the question. Either conclusion (positive or negative view by A.M. Best) could have received full credit if explained well.*

*Some candidates did not state an opinion on whether A.M. Best would view this as a positive or negative development, but rather put together a pros/cons list. Candidates doing this only received partial credit. When asked to take a position, candidates should do so. It is fine to show arguments for and against the position being taken, but the candidate should then balance the pros and cons and make a choice.*

The SPV may be viewed as more desirable than reinsurance because it addresses these two points:

- A.M. Best is concerned with Hamsik's dependence on third-party reinsurance
    - The SPV would reduce their credit exposure to Bourbon Re
    - The SPV would have access to a dedicated pool of funds in the event of a catastrophic weather event
  - As Hamsik would offload the catastrophic weather risks to the SPV, Hamsik would not be financially responsible for losses above a certain threshold, thus helping it avoid material losses and avoid capital deterioration in these catastrophic situations.
    - Since the SPV is bankruptcy remote and is a separate legal entity, there is a layer of protection such that the SPV could not legally come after Hamsik's assets in the event of insolvency and Hamsik would not have to bail the SPV out.
- (e) Explain key risk exposures not addressed by the SPV that A.M. Best would also consider in its rating opinion of Hamsik.

### **Commentary on Question:**

*In this section, many candidates referenced risk exposures around the SPV (often just repeating answers to earlier parts of the question). This question part was asking for a more general discussion of other types of risks that Hamsik faces. It was testing knowledge of A.M. Best criteria and the ability to relate those criteria to Hamsik's specific situation. Four distinct risk exposures needed to be explained for full credit.*

- High geographic concentration in states prone to tornadoes (i.e. the Midwest)
- No product diversification to help offset risks in property line
- Agreement may not cover all types of property damage (hurricanes, earthquakes, etc.)

#### **4. Continued**

- Pricing and underwriting risks, which would lead to adverse loss reserve development and challenge operating results and capitalization
  - Selling products in different geographical locations not currently covered
  - Changing weather trends that could cause higher likelihood of disasters
  - Product design risks that allow policyholders to control various elements of the product.
- Are Hamsik's EC and Catastrophe models accurately modeling its catastrophic exposures and thus capital requirements?

## 5. Learning Objectives:

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:

- (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.
- (4j) Analyze the application of Asset Liability Management and Liability Driven Investment principles to Investment Policy and Asset Allocation.
- (5e) Propose techniques for allocating/appropriating the cost of risks/capital/hedge strategy to business units in order to gauge performance (risk adjusted performance measures).

### Sources:

ERM-111-12: Key Rate Durations: Measures of Interest Rate Risks

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

### Commentary on Question:

*Candidates should understand the Strategic Asset Allocation process and how it applies to risk management. Candidates should also understand the implications to the ALM process given different scenarios such as specific liability profiles and varying economic circumstances.*

### Solution:

- (a) Describe the processes and considerations involved in implementing each of the first four steps in the SAA framework above.

### Commentary on Question:

*This question was relatively well done. Most candidates could describe the process and provide appropriate considerations for each step.*

Step 1: Objectives and Constraints: Objectives are generally a targeted yield, within some level of risk tolerance or duration mismatch limit. Objectives (and constraints) can be iteratively revisited depending on the risk or return metric decision in the later steps of the ALM process. Constraints can be set based on rating classes, type of assets, or asset concentrations.

## 5. Continued

Step 2: Asset Universe and Asset Assumptions: For the asset universe, allowable asset classes are established or available assets are identified. Asset assumptions could include default risk, correlations between assets or classes, etc.

Step 3: Liability CF and Replicating Portfolio: Consider the liability profile including best estimate liabilities, optionality or volatility of CFs, and term. Establish the key rate duration profile of the liabilities and where possible create a replicating portfolio of assets to match the KRD profile and other economic characteristics of the liabilities.

Step 4: Risk Measures: Establish a set of different risk metrics that will be used in the risk-return decision-making of setting the SAA. It is important to be a set, because a single risk metric doesn't give a complete picture. Examples include Surplus Volatility, Economic Capital or Required Capital.

- (b) Explain how the attributes of the liabilities would influence each of the first four steps of the SAA process, for each of the three blocks of business.

### **Commentary on Question:**

*Candidates did relatively well here. Many candidates however did not state any objectives or constraints when answering the question.*

GICs: The objective could be a spread over the guaranteed interest rate. For the asset universe, consider high quality fixed income/treasuries restricted to 5 year maturities. Allow for the assets to handle liquidity demands for surrenders (e.g., a percentage can be cash). Liabilities are medium term in nature and a replicating portfolio can be easily created. In terms of risk measures, the profitability may be sensitive to lapses, so a lapse sensitivity could suffice.

SPIA: The objective could be to duration match shorter term liability cash-flows, and then set a constraint on the return of the portfolio. For the asset universe, we have to consider the long term nature of liabilities, so consider the risk-return profile of long term fixed income. Also consider that there may not be available assets long enough to match certain durations so consider derivatives or Non-Fixed Income for total return matching. The liabilities are long term so a replicating portfolio may be difficult to construct. For a risk measure consider interest and longevity sensitivities and the implications to surplus drawdown.

Hurricane Insurance: We want to meet liquidity demands of the short-term liabilities, as well as capital demands. The asset universe could be short-term assets and liquid assets for the volatility of the liabilities. The liability profile is short-term, with low frequency / high severity events. Also, the events are likely seasonal. Since it is a catastrophic event, we may want to consider the tail of the distribution with a CTE metric.

## 5. Continued

- (c) Mardi Gras has historically managed capital based on regulatory requirements, but is now considering using Economic Capital (EC).

Explain how this change in focus to EC could influence the SAA analysis.

**Commentary on Question:**

*This was the lowest scoring part of this question. Candidates often did not make any statements regarding the use of regulatory capital. Some candidates simply listed out all they could remember about Economic Capital without any application to the question. That is a waste of the candidate's time and does not score points since it is not answering the question asked.*

The Economic Capital measure is often tied to a VaR or CTE metric at a given confidence level of the total balance sheet requirement for solvency for a specific time period. Regulatory capital is often a formulaic/deterministic metric tied to surplus such as the case for RBC or MCCSR (Canada). For the asset universe, the impact of using different assets would change EC (as it values assets on a realistic basis) and regulatory capital (as it may use a factor approach on the asset class) differently. Since the sensitivities of regulatory capital and EC may be different, constraints could be different and threshold for risk measures could change. The metrics have no real effect on the existing liability CFs, but may influence new product decision making.

- (d) Explain the implications to the first four steps of the SAA process if Mardi Gras managed these three blocks of business in aggregate, instead of separately.

**Commentary on Question:**

*This question could have been answered more fully. Most candidates did not give too much thought to a complete answer, and often just stated that there would be diversification without relating back to the steps.*

**Objectives and Constraints:** We may demand more return for risk because of diversification benefits, or the risk constraints may be lowered.

**Asset universe:** Needs to be expanded as compared to a single line of business. We now need to handle the volatility from hurricane insurance, the long duration of SPIA, and fixed income assets from the GIC.

**Liability CF/Replicating Portfolio:** Liability effects are aggregated, which would change the KRD profile and thus the replicating portfolio.

## 5. Continued

Risk Measures: Risk metrics are changed to reflect the new aggregate liability and should consider the diversification benefits. We may now want to use a common risk metric. Also the set of risk metrics should be used to understand and encompass all the risks backing all the products and considering if some risks may offset.

- (e) Explain how the perspective gained from the economic crisis of 2007-2009 may have impacted Mardi Gras' analysis in the first four steps of the SAA process.

**Commentary on Question:**

*Some candidates did all right with this question, but many others did not. A lot of candidates did not think about how the asset universe might change. Some candidates also elected to expound on all they knew about the 2007-2009 crisis without real application to the question.*

As a result of the crisis the objectives and constraints may have become more defensive. For instance, there might now be more asset constraints and/or liquidity constraints.

The Asset Universe will likely change: Mardi Gras might have disallowed certain asset classes because of credit rating impacts, hedging instruments may have been introduced, and other assets may be deemed riskier than previously assumed (e.g., Credit default swaps) and are therefore no longer included.

For the liability CFs, Mardi Gras may have considered modifying certain liabilities (for example, lowering crediting rates or shortening guarantee periods), might be more careful about considering policyholder behavior changes, and changes might be made to future product designs.

For risk metrics, Mardi Gras may consider a greater array of risk metrics (such as EC, or RAROC) and consider changing the tolerance of risk metrics. The company may have introduced an extreme market scenario sensitivity.

## 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.

### 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, project risk and strategic risk

### Sources:

ERM-107-12: Strategic Risk Management Practice, Andersen and Schroder, Ch. 7

### Commentary on Question:

*The quality of answers varied widely. Many candidates did not recall the “Scenario Planning Approach” as detailed in the source, but used other material from the same reading. Partial credit was given for other reasonable strategic risk management approaches, if appropriately applied.*

*Candidates frequently did not answer the question as posed, in particular when asked to “explain” or “recommend”. Some candidates did not focus on strategic risk in their answers, instead discussing a wider range of risks; this was a misuse of the time available as credit was only given for strategic risk responses.*

*As noted in the question, candidates had a choice of clients to focus on. The intent was to let candidates choose the industry they felt most comfortable assessing. The Las Vegas Casino Association was the entity chosen most often, and it is used in this model solution*

### Solution:

- (a)
  - (i) Identify the steps in the Scenario Planning Approach used in strategic risk management.
  - (ii) Apply the Scenario Planning Approach for the client you have chosen, showing your responses for each step in the process.

### Commentary on Question:

*Scenario Planning Approach is described on pages 162-166, and there are five steps detailed. Many candidates were able to identify at least some of the steps.*

*Some candidates confused PESTEL or SWOT with the Scenario Planning Approach. Points could be received for applying PESTEL or SWOT, if the answer related to strategic risk management and development of scenarios.*



## 6. Continued

*Part (a)(i) was directly from the source material. Part (a) (ii) required the candidate to apply the approach and, by solving a problem, demonstrate understanding of fundamental strategic risk management ideas developed in the reading.*

*In part (a)(ii), at least two separate sources of strategic risk were necessary for full credit, and, in addition, the combination of themes in developing scenarios was necessary for full credit. There were candidates who detailed operational or financial risk sources in their responses rather than strategic.*

*The model response below is an example, and alternative answers also received credit.*

- (i) Steps in Scenario Planning Approach:
  - Step 1 – Identify environmental risk factors
  - Step 2 – Elaborate major themes that characterize plausible alternative developments for future competitive market conditions
  - Step 3 – Elaborate on the major themes and describe some scenarios that arise as a consequence of different assumptions
  - Step 4 – Evaluate the consequences of key strategic risk factors within the alternative scenarios and assess capacity for corporate responsiveness
  - Step 5 – Formulate new strategic alternatives, if required, and evaluate them in the different scenarios.
  
- (ii) Apply Scenario Planning Approach using the Las Vegas Casino Association:
  - Step 1 – Environmental risk factors:
    - 1. Online gambling
    - 2. Airline ticket prices
  - Step 2 – Elaborate major themes:
    - 1. Online gambling becomes more popular so fewer gamblers visit LV casinos
    - 2. Increasing ticket prices deter people from traveling to LV as a gambling or vacation destination

## 6. Continued

Step 3 – Elaborate on major themes and describe some scenarios:

		Online Gambling Popularity	
		Low	High
Airline ticket prices to LV	Low	Status quo – people still traveling to Las Vegas	Online gambling becomes more popular – opportunity for LV casinos to form partnerships with online gambling sites
	High	Travel prices too costly so less visitors to LV – opportunity for LV casinos to develop relationships with smaller regional casinos; may result in losses to LV casinos	Travel costly and online gambling more popular – probable losses to LV casinos

Step 4 – Evaluate consequences of key strategic risk factors within themes:

1. Current business model is based on gamblers’ and other tourists’ physical presence in LV, and this is too narrowly focused a market. Other opportunities include insurance for gambling websites, developing own gambling websites (or partnering), or developing relationships with local or regional casinos

Step 5 – Formulate strategic alternatives and evaluate them in different scenarios:

1. Market insurance product to online gambling sites or non-LV casinos; may provide significant revenue if websites or local casinos become much more popular
2. Develop alternative, non-gambling related products attracting a wider range of potential clients (make LV more than a gambling destination); should be profitable in any scenario but may require additional resources and expertise to develop

- (b)
- (i) Explain what should be considered when choosing participants for the environmental scanning task force.
  - (ii) Recommend one approach for your client’s task force to take when scanning the environment.
  - (iii) Recommend two specific key risk indicators to be monitored.

### Commentary on Question:

*Candidates were generally able to obtain at least partial credit for (b). Part (b)(i) is basically looking for diversity in the task force, but as the item requires candidates to “explain”, for full credit the answer must include “why”.*

## 6. Continued

*For part (b)(ii) candidates receive full credit only if they described and recommended one of the four possible approaches.*

*Part (b)(iii) looks for key risk indicators consistent with the answer to part (a). Often candidates would list KRIs but without explanation or sufficient specificity. Some candidates chose KRIs that could not reasonably be monitored.*

(i)

- Involve people who are observant and sensitive to changes in risk environment in order to recognize environmental changes early and allow for quicker reaction.
- Include a mix of people currently in casino industry at different levels (e.g., front line worker, manager, etc.) and different functions (e.g., marketing, finance, customer service, etc.) in order to have an understanding of different facets of the business and possible risk concerns.
- If possible include others with experience in industries that have experienced similar strategic threats, which could perhaps be a board member.

(ii)

- Undirected viewing is recommended for complex or volatile environments. This involves scanning many diverse sources of information without specific informational needs, and may be best to sense new trends and think about developments in unconventional ways.

(iii)

- Number of visitors to online casinos, to help determine if there is a movement away from casinos to online gambling
- Cost of airfare from selected cities to LV

## 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.
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:

- (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, project risk and strategic risk.
- (4b) Demonstrate and analyze applicability of risk optimization techniques and the impact on an organization's value of an ERM strategy.
- (5c) Explain the challenges and limits of economic capital calculations and explain how economic capital may differ from external requirements of rating agencies and regulators.
- (5d) Apply risk measures and demonstrate how to use them in economic capital assessment. Contrast and understand regulatory, accounting, statutory and economic capital.

### Sources:

ERM-106-12: Economic Capital – Practical Considerations, Milliman

Risk Appetite: Linkage with Strategic Planning

### Commentary on Question:

*This question was focused on SLIC's term product risk, but asked the candidates to take a broader view of how product changes could affect various types of risks and Economic Capital. To do well, candidates needed to relate their answers to the specifics of SLIC.*

### Solution:

- (a) Identify and explain three key concerns specific to the existing SLIC term block. Substantiate your response using the case study.

### Commentary on Question:

*Candidates generally did well in both identifying and explaining key concerns around the existing term block. Three appropriately explained concerns were needed for full credit. The answer below gives a longer list.*

## 7. Continued

- Mortality concerns include poor experience, limited underwriting on simplified issue with high face amounts, and a mortality assumption that includes 100% non-smoker sales distribution.
- Persistency concerns include lower lapse rates than expected, which is concerning given the poor mortality experience. The high first year commission also presents a risk that high lapse rates could result in losses if the lapse occurs before acquisition costs are recovered.
- The reinsurance strategy, which retains a high net amount at risk, may be inconsistent with SLIC's risk appetite statement.
- The economic capital model does not incorporate mortality risk, which is the most impactful risk for term business.
- Pricing concerns include premiums that are 20% lower than the nearest competitor. This could result in future losses if aggregate premiums are inadequate to cover aggregate benefit payments, which could be particularly problematic if the significantly lower price also generates high sales volumes.

(b) For each of mortality risk, credit risk, market risk and operational risk:

- (i) Indicate how each of the changes, I through IV, would affect SLIC's overall risk exposure: Increase, Decrease, No change or Uncertain.

Justify your response for each combination of risk and proposed change.

- (ii) Indicate how each of the changes, I through IV, would affect SLIC's total Required EC: Increase, Decrease, No change or Uncertain.

Justify your response for each combination of risk and proposed change.

### **Commentary on Question:**

*Candidates were generally successful in providing correct impacts, though sometimes the justifications didn't match the impact, or frequently were not provided at all. Candidates who performed well justified each of the impacts.*

*In most cases, there was not a single right answer on the impact because different underlying assumptions could be made, so various responses could receive up to full credit if appropriately justified. Better responses included a statement of any assumptions made by the candidate.*

## 7. Continued

(i) Impact on overall risk exposure

Terminate sales of the 20 and 30 year term product, which is expected to result in higher UL sales	
Mortality risk exposure	Decreases since term uses simplified underwriting on high face amounts while UL uses medical underwriting. The term block also has poor mortality experience and anti-selection issues with aggressive agents and high first year commissions.
Credit risk exposure	Increases since the UL block uses an asset allocation with lower credit quality than term.
Market risk exposure	Increases since the UL block invests in riskier assets than term, which increases market volatility and uncertainty of returns.
Operational risk exposure	Increases since the UL product is more complex and the system used to administer it has proven to be inadequate.

Add a rider which accelerates payment of death benefits upon diagnosis of a terminal illness of the insured	
Mortality risk exposure	Increases because the company will have to pay the death benefits in an accelerated time frame. Since the term block has anti-selection issues and poor mortality experience, this rider could add additional risk. The company may also end up paying on cases where it otherwise would not have paid at all if the death does not occur during the term of the policy.
Credit risk exposure	Investments and mortality experience are independent of each other, so changing mortality risk has no impact on credit risk
Market risk exposure	Investments and mortality experience are independent of each other, so changing mortality risk has no impact on market risk
Operational risk exposure	There is an increased chance of operational error since SLIC does not have experience offering this type of rider in the past.

Shift asset portfolio credit quality from A rated to BBB rated assets	
Mortality risk exposure	Investments and mortality experience are independent of each other, so changing investments has no impact on mortality risk

## 7. Continued

Credit risk exposure	Shifting to riskier investments increases the likelihood of default and increases credit risk
Market risk exposure	Shifting to riskier investments increases volatility and increases market risk
Operational risk exposure	No change in operational risk since it is only a small change to asset allocation. There are no changes to systems or processes.

Add a mortality component to economic capital model	
Mortality risk exposure	Adding the component to the model will not impact mortality risk since it impacts only the modeled world, not the real world. However, if adding the component to the model helps the company better understand its exposure to mortality risk it may enable the company to take action to decrease the mortality risk.
Credit risk exposure	No impact since it impacts only the modeled world and does not impact the investment portfolio.
Market risk exposure	No impact since it impacts only the modeled world and does not impact the investment portfolio.
Operational risk exposure	No significant impact since it impacts only the modeled world, although it could result in an increase in model risk.

### (ii) Impact on Required EC

Terminate sales of the 20 and 30 year term product, which is expected to result in higher UL sales	
Mortality impact on required economic capital	SLIC has not yet implemented any methodology to capture insurance risk in the EC model, so in the current situation, there would be no impact on the calculated EC.
Credit impact on required economic capital	Increases since the UL block uses an asset allocation with lower credit quality than term.
Market impact on required economic capital	Increases since the UL block invests in riskier assets than term, which increases market volatility and uncertainty of returns.
Operational risk impact on required economic capital	The operational risk component of the EC model is a function of liabilities; the UL liabilities will likely be higher, so the required EC would increase.

## 7. Continued

Shift asset portfolio credit quality from A rated to BBB rated assets	
Mortality impact on required economic capital	Investments and mortality experience are independent of each other, so changing investments has no impact on the underwriting component of the EC model
Credit impact on required economic capital	Shifting to riskier investments increases the likelihood of default and increases credit risk, so the credit component of the EC model would increase
Market impact on required economic capital	Shifting to riskier investments increases volatility and increases market risk, so the market component of the EC model would increase
Operational risk impact on required economic capital	No change in operational risk since it is only a small change to asset allocation. There are no changes to systems or processes.

Add a mortality component to economic capital model	
Mortality impact on required economic capital	SLIC is exposed to a large amount of mortality risk. This is not currently being accounted for in the model, so adding it to the model will increase the required EC.
Credit impact on required economic capital	No impact since there is no change to the investment portfolio.
Market impact on required economic capital	No impact since there is no change to the investment portfolio.
Operational risk impact on required economic capital	No impact since there is no change to operational risk.

- (c) Explain which two of the four contemplated changes will be of the most concern to the rating agencies. Justify your response.

### **Commentary on Question:**

*Candidates typically were able to identify which of the contemplated changes would be of most concern to the rating agencies, and effectively explain the issues. The two changes shown in the model solution below were the expected responses. Candidates who chose one of the other changes could receive close to full credit if the choice was justified well.*

The two changes that would likely be of most concern are ones that would increase SLIC's risk profile. The rating agencies may be concerned that SLIC is not capitalized well enough to manage through the expected increase in required capital and earnings volatility. Rating agencies look to stable, or improving, operating performance and a strong business profile.



## 7. Continued

Terminate term sales:

- Rating agencies have expressed concern with the trend toward a higher risk profile in the insurance industry. Term tends to be a stable product with relatively predictable cash flows. The UL product, that is intended to replace term sales, has a crediting rate guarantee of 3%, which may be difficult to meet in the current low interest rate environment. This change in product portfolio will increase SLIC's overall risk profile and could make future earnings more volatile.

Shift asset portfolio:

- A primary tool used by rating agencies is an analysis of balance sheet strength. The risks inherent in the investment portfolio are part of this analysis. Thus, increasing allocation to BBB rated assets will lead to managing assets with higher credit spreads, which could result in higher earnings volatility and may lead to a higher risk of defaults.

Adding a mortality component to the EC model would probably be viewed favorably by the rating agencies, as they are expecting companies to develop appropriate internal capital models. Adding the accelerated death benefit rider could increase SLIC's liability risk profile, but probably not significantly enough to be a big concern; and because it is a benefit offered by competitors, the rating agencies could see this as a necessary competitive action.

- (d) Outline the impact of each of the contemplated changes on marketing and sales.

### **Commentary on Question:**

*Candidates performed very well on this section, outlining several potential impacts on marketing and sales.*

Potential impact on marketing and sales:

- Agents will not like the termination of term sales as it limits the product portfolio and eliminates a high commission product.
- Agents will like the terminal illness rider as it adds a feature to a product they already like selling.
- The change in the asset portfolio should have a minimal impact on sales unless the change can add enough incremental yield to improve pricing.
- Adding a mortality component to the EC model should have almost no impact on sales as the market will not be aware of the change to the company's internal models. However, it could reduce sales if the change causes the company to better understand the mortality risk it faces and leads to changes in underwriting and pricing.

## 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.
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, project risk and strategic risk.
- (4e) Demonstrate how derivatives, synthetic securities, and financial contracting may be used to reduce risk or to assign it to the party most able to bear it.

### Sources:

Financial Enterprise Risk Management, Sweeting Ch. 8 Risk Identification

ERM-401-12: Mapping of Life Insurance Risks

ERM-402-12: Countering the Biggest Risk of All

SOA 2012 Annual Meeting – Session 53 – Assumption Setting Best Practices, Towers Watson

### Commentary on Question:

*This question tested candidates' ability to analyze the risk impacts of the introduction of a new product as well as the appropriateness of assumption setting. Candidates were provided with extensive information on the proposed product in the case study, which allowed candidates time to think about the potential product issues in advance of the exam.*

### Solution:

- (a) Explain how each of the following risks, for SLIC, would be affected by the introduction of the proposed Indexed UL product:
  - (i) Equity market risk
  - (ii) Pricing risk
  - (iii) Operational risk

## 8. Continued

### **Commentary on Question:**

*Many candidates struggled with the concept of the swap contract, not fully understanding that the majority of the equity risk was being transferred to a third party. Most candidates were able to adequately describe the impacts to pricing risk and operational risk. The answers provided below are more complete than would be needed for full credit.*

- (i) Little to no equity market risk would be added by the Indexed UL product, since the performance of the Indexed fund is hedged using a swap. The risk that may arise would be basis risk from the timing difference between when the premiums are received and when SLIC purchases the swap.
  - (ii) New pricing risks arise in executing the hedging, both in terms of hedge amounts and executing the swap contracts in a timely manner. A new pricing risk is introduced when determining the declared cap rate on the fund -- if it is too high, the investment income may not be high enough to cover the price of the hedges. SLIC's lack of experience with pricing the new product introduces additional risk. The ability of the policyholders to choose the proportion of fixed account vs. index account for new premium introduces a risk due to the challenge of modeling policyholder behavior accurately.
  - (iii) Operational risk arises due to the need for additional tracking and monitoring of policy attributes, as well as interaction with a new counterparty. Updates to systems and required personnel training all introduce new operational risks.
- (b) Compare the interest rate risk for the Indexed UL product to the existing UL product.

### **Commentary on Question:**

*To receive full credit candidates needed to discuss the interest rate risk of both the Fixed and the Indexed Accounts under the Indexed product, and compare the risks to the existing UL product.*

The interest rate risk on the Indexed UL product is lower because it has a 2% guarantee on the Fixed Account (compared to 3% on the existing UL product), and a 0% guarantee on the Indexed Account. In addition to the lower guaranteed rates, the new Indexed UL product can adjust the cap rate up or down depending on the hedge costs or investment performance.

- (c) Explain strategic considerations that should influence SLIC's decision regarding the introduction of the Indexed UL product.

## 8. Continued

### **Commentary on Question:**

*Many candidates did not fully understand the concept of a “strategic” consideration. Candidates who discussed pricing issues or other unrelated considerations did not receive points for that part of their answer.*

SLIC may make a strategic decision to proceed due to:

- Experiencing lower than desired sales in the current UL product; introducing a new product should help sales.
- Desire to diversify away from Term more quickly by increasing sales in accumulation-type products.
- If the introduction of the Indexed UL product results in lower or better diversified required capital or Economic Capital.

SLIC may make a strategic decision not to proceed due to:

- The potential for cannibalism with the existing UL product.
- The effect introducing an indexed product has on the company’s overall risk profile with added counterparty risk and more exotic derivatives, especially in a stressed environment.
- If the introduction of the Indexed UL product results in higher required capital or Economic Capital.

(d) Explain whether or not the following UL-based assumptions are appropriate for the proposed Indexed UL product.

- (i) Mortality
- (ii) Lapse/Surrender
- (iii) Operating expenses
- (iv) Policyholder premium payment behavior

### **Commentary on Question:**

*Many candidates performed well on this part of the question and adequately explained their answers for each subpart.*

- (i) UL mortality experience is likely appropriate for the new Indexed UL product. This assumes the UL experience supports the range of issue ages and policy size bands expected in the new Indexed UL product.

## 8. Continued

- (ii) The Indexed UL product will need more complicated lapse assumptions. Since interest is only credited annually on the policy anniversary on the Indexed UL policies, it may be reasonable to expect that voluntary surrenders are more likely to occur just after anniversary. Also, since the policyholders will likely behave reactively to the equity market, a dynamic component may be required for the lapse/surrender assumption for the new Indexed UL product.
- (iii) Due to the complexity of the new indexed interest crediting as well as the hedging, it may be appropriate to assume greater operating expenses on the new Indexed UL compared to the existing UL product.
- (iv) Similar to the lapse/surrender assumption, policyholders may deposit premium reactively according to equity market movements. Using the base existing UL assumption with an additional dynamic component for deposits into the Indexed Account may be necessary for the new Indexed UL product.