

Exam ERM-GH

Date: Tuesday, October 30, 2018

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 extension readings and/or 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 because 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.

Recognized by the Canadian Institute of Actuaries.

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.** (7 points) ReaLife Insurance Company sells life insurance products. The performance of different functions (e.g. Investment, ALM and Business Management) in the company is measured using the Economic Value Added (EVA) measure.

ReaLife’s investment policy defines the Strategic Asset Allocation (SAA) and the Tactical Asset Allocation (TAA) range which applies to the combined liability and surplus investment portfolio.

Asset class	SAA	TAA range
Short-Term Bonds	50%	45% to 55%
Long-Term Bonds	50%	45% to 55%

Investments in both asset classes must total 100%. No cash position is allowed.

The current investment portfolio, which matches the SAA, is given below.

Asset Class	Market Value of Assets (\$ million)	Duration	Expected Return
Short-Term Bonds	100	5	4.0%
Long-Term Bonds	100	20	5.0%
Total	200	12.5	4.5%

You are given the following information:

- The company’s Market Value of Liabilities is \$180 million with a duration of 15 years.
- The fixed income benchmark portfolio for the liabilities has a duration of 15 years and value of \$180 million.
- The expected return of the benchmark portfolio is 4.5%.
- Cost of capital is 4%.

The required capital for duration mismatch risk = \$10 million times the duration mismatch.

Assume the following interest rate changes occur at the end of the current performance measurement period:

- 5-year interest rate increases by 0.5%.
- 15-year interest rate decreases by 0.5%.
- 20-year interest rate decreases by 0.5%.

1. Continued

- (a) (4 points) The Investment function anticipated the market movement correctly and positioned the portfolio at the beginning of the measurement period to maximize the function's performance measure according to the limits imposed by the TAA.
- (i) Verify that EVA for the Investment function = 0.95. Show your work.
 - (ii) Verify that EVA for the ALM function = -6. Show your work.
 - (iii) Recommend an action to improve EVA for the ALM function.
- (b) (3 points) ReaLife's Business Management function manages new business and nonfinancial risk such as insurance and operational risks.

You are given the following information:

- During the measurement period, the market consistent embedded value of new business underwritten is \$1 million.
 - The new business sales are at the maximum allowed by the available capital for new business.
 - The experience of nonfinancial risk has an adverse deviation of -\$2.4 million from the best-estimate assumption due to unfavorable mortality experience.
 - The maximum of statutory required capital, rating agency required capital and required economic capital at the desired probability is \$30 million.
- (i) Calculate EVA for the Business Management function.
- (ii) ReaLife's senior management is not satisfied with the performance of the Business Management function with regard to new business and has asked you to explore the use of these two types of reinsurance to improve it:
- I. Pro rata
 - II. Excess of loss

Recommend one of these two types of reinsurance for this purpose. Justify your recommendation.

2. (10 points) You are a recently hired CRO at XYZ Company. XYZ has 30% of its invested assets in a mining company, MC. The investment has performed well, but XYZ is growing uneasy that volatility in the commodity market may reduce the value of XYZ's shares in MC.

You've been asked to investigate establishing a hedge of the MC shares.

- (a) (1 point) XYZ's Chief Investment Officer (CIO) is familiar with VaR and wants to use it as the risk measure. You would like to use Monte Carlo methods to evaluate the effect of the hedge but your department is struggling with computer runtime issues in trying to generate stochastic Monte Carlo results.

Propose an alternative technique that could lead to a faster and more accurate VaR estimate. Justify your response.

- (b) (3 points) The CIO is convinced that hedging is the right risk management approach. As there are no exchange-traded options for this commodity, the trade would be executed in the OTC market. There is concern from the Board of Directors (BoD) about managing the counterparty risk.

- (i) Explain how Expected Mark to Market, Expected Exposure and Potential Future Exposure quantify the company's counterparty credit exposure to the OTC counterparty. Use graphs to support your explanation.

You propose creating a Risk Dashboard to be reported monthly to the BoD.

- (ii) Recommend which one of the metrics in part (i) you would reflect in the Risk Dashboard. Justify your recommendation.

- (c) (2 points) The BoD has asked you to create a plan for implementing the commodity hedge. The company has an existing hedge program to manage its interest rate risk exposure. Your colleague sends you a brief email:

"Great news on the board approving the hedge plan! Now we just need additional master agreements with our counterparty to reflect this new risk, and since we were already hedging interest rate risk there's no need to update the firm's risk tolerance statement."

Critique your colleague's message.

2. Continued

- (d) *(4 points)* In preparation for your annual report to the BoD on the company's solvency and risks, your Risk Management Team is reviewing the list of key risks on the company risk register.

Identify and describe four risk exposures that have changed because of the new commodity hedge. Justify your response.

3. (14 points) You are a risk actuary working in insurer ABC's ERM department. Your task is to improve operational risk assessment at ABC. Two potential approaches are being proposed to model operational risk exposure – the Risk Map approach and the Actuarial approach – as outlined below.

	Risk Map Approach	Actuarial Approach
Owner	Individual business line manager	ERM department
Operational Risks	<ul style="list-style-type: none"> - Routine Operational Risks <ul style="list-style-type: none"> • People • Process • IT/Systems - Exceptional Operational Risks <ul style="list-style-type: none"> • External events • Sales and business practices 	
Model Components		
Exposure / Capital measure	<ul style="list-style-type: none"> • Expected loss 	<ul style="list-style-type: none"> • VaR
Calculation method	<ul style="list-style-type: none"> • <u>Frequency</u>: not defined • <u>Severity</u>: impact on ABC's financial condition 	<ul style="list-style-type: none"> • <u>Frequency</u>: no statistical assumption defined yet • <u>Severity</u>: direct and indirect impact • <u>Interaction</u>: historical correlation matrix
Data and assumptions	<ul style="list-style-type: none"> • Based upon business line manager's own loss experience / expert judgment 	<ul style="list-style-type: none"> • Internal data only
Business environment	<ul style="list-style-type: none"> • Line manager believes that their model is appropriate both for routine and exceptional risk events 	<ul style="list-style-type: none"> • Control indicators based upon on each business line manager's input • Appropriate both for routine and exceptional risk events

3. Continued

- (a) (6 points) The following six principles are relevant to assess the validity of any model used for risk purposes.

Model Feature	Principle
Design	Consistent with intended purpose
Validation	Part of an independent process
Owner	Accountability stated and applied
Complexity & Materiality	Proportional to context
Elements	Inputs, calculation, output, and limits must be validated
Documentation	Analysis of supporting details produced

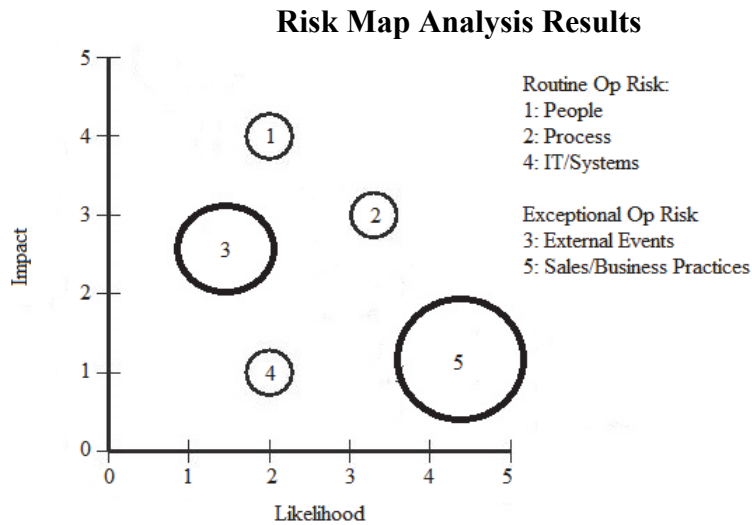
Compare and contrast the application of each principle relative to both proposed operational risk modeling approaches. Justify your response.

- (b) (4 points) Assess the appropriateness of the proposed actuarial approach to adequately model both routine and exceptional operational risk exposures. Justify your response by discussing the suitability of each model component.

Question 3 continued on the next page.

3. Continued

(c) (4 points) You obtained the following results for the risk map approach as compiled by one of the business line managers.



In addition, the ERM team has just performed the following operational analysis.

Operational Risk Analysis Results

Risk Category	Annualized frequency	Direct impact on ABC equity	Indirect impact on ABC
1. People	Fraud: 0.1%	Legal fines: 10%	Not assessed historically
2. Process	Claims failures: 0.5%	Corrections: 2%	Negative social media suspected
3. External events	Terrorism: N/A internally	Lost sales: 10%	Highly negative short-term on traded ABC stock
4. IT/Systems	IT failures: 0.1%	Downtime: 0.1%	Not likely
5. Sales and business practices	Selling inadequate products: 1%	Legal fines: 20%	Highly negative on reputation

Recommend improvements to the individual business line manager based on the ERM department's analysis with respect to each of the following items. Justify your response.

- I. Collection of data relevant to modeling of operational risk losses
- II. Ensuring accuracy of operational risk loss data
- III. Setting of assumptions for variables used in operational risk modeling.

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4. (10 points) The National Cardiologist Medical Association (NCMA) is currently insured with PQR, an insurance company licensed in the U.S. PQR specializes in liability insurance against medical malpractice of its members. Due to the constant rise of premiums charged by PQR, NCMA, along with other medical associations, has created a pure captive Risk Retention Group (RRG) to self-insure against malpractice claims.

RRG is domiciled in the United States and is also responsible for claims handling and administration.

You are a consulting actuary working for RRG and are responsible for setting premiums rates and implementing its risk management framework.

- (a) (3 points) Compare and contrast the characteristics of PQR and RRG as they relate to the following:

- Target Market
- Required Risk Capital
- Regulation
- Policyholder Protection

- (b) (2 points) Explain how the exposure to each of the following risks will affect the associations participating in RRG. Justify your response.

- Catastrophe Claim
- Investment Risk
- Operational Risk
- Legal Risk
- Regulatory Risk

4. Continued

- (c) (3 points) You decide to use Economic Capital as the primary tool to quantify material risks and assess performance for pricing. Your team provided projection of selected RRG's income statement and balance sheet items for the first year (in \$ million).

Income Statement	Year 1
Premium	11
Maintenance Expenses	2
Expected Claims	5

Balance Sheet	At Issue	Year 1
Policy Liability	20	25
Market Value Assets	80	90
Available Economic Capital	50	55
Required Economic Capital	40	40

You are also given:

- Risk adjusted net income is assumed to be 70% of net income before tax
- Tax rate is 25%
- Interest on reserve and available capital is 5%
- Only cash and short-term notes back the required capital; therefore, investment income on required capital can be ignored

- (i) Calculate the following metrics. Show your work.

- ROE
- RAROC

- (ii) Propose an additional risk metric appropriate for assessing RRG's performance based on the data given. Justify your response.

- (iii) After assessing the metrics produced by your analysis, your colleague makes the following statement:

"I recommend we adopt RAROC as the primary risk metric for evaluating the performance of RRG as it currently produces a higher return than all other metrics considered."

Critique your colleague's recommendation.

Question 4 continued on the next page.

4. Continued

- (d) (2 points) Based on the metrics considered, RRG is not performing well after one year of operation.

Recommend two risk mitigation strategies that could improve RRG's performance.

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5. (10 points) OSZ, a life insurance company in Country A, is considering offering a product linked to the return on a pool of cryptocurrencies. Premium and benefit payments are denominated in Country A's currency, ACU.

Historically, the pool of cryptocurrencies has experienced excessively high volatility.

Country A regulators have indicated to OSZ that capital requirements for such a product would be extremely high, which would not allow OSZ to meet profit targets for this product.

OSZ is considering the use of a Special Purpose Vehicle (SPV) to finance the new product. The SPV would have the following structure:

- Separate legal entity from OSZ
 - Payments to investors are proportional to their initial investments
- (a) (1.5 points) Identify three key benefits to OSZ from using an SPV for the new product. Justify your response.
- (b) (2 points) The following risks are generally associated with the use of SPVs:
- Liquidity and funding risk
 - Reputational risk
 - Lack of transparency
- (i) Describe each risk as it pertains to an SPV.
- (ii) Rank the risks based on relevance to OSZ's proposed SPV. Justify your ranking.

5. Continued

OSZ decided to offer the product using an SPV.

Benefit payments, B_t , occur at the end of each year as follows:

- Initial Benefit Payment: $B_1 = \frac{80\% \text{Single Premium}}{120 - \text{Issue Age}} \max(1, 1 + 40\%R_1)$
- Subsequent Benefit Payments: $B_t = B_{t-1} \max(1, 1 + 40\%R_t)$,

R_t is the percent return in year t on the pool of cryptocurrencies.

You are given the following information:

- 10 policies were issued on the same day exactly two years ago; all policies are in force today
- Each policy was issued at age 65 for a single premium of 1,000,000 ACU

You are also given the following capital management policy:

- The only changes in capital are from payments to policyholders, distributions to investors and investment returns on capital
- Required Capital (per policy)
 - For $t = 0$: 200% Single Premium
 - For $t > 0$: $\max(B_t, 200\%(120 - \text{Attained Age})B_t)$
- Capital is invested in an annually rebalanced portfolio containing 40% of the cryptocurrency pool earning R_t and 60% earning a fixed 6% return
- At the end of each year, after payments have been made to policyholders, any capital in excess of 125% of required capital is distributed to the investors

(c) (4 points) You've created a table to track capital and distribution to investors.

t	Attained Age	R_t	B_t	Capital Requirement	Capital Before Distribution to Investors	Distribution to Investors	Capital After Distribution to Investors
0	65	N/A	N/A		25,000,000	N/A	
1	66	25%					
2	67	-75%				0	

- Determine the missing values. Show all work.
- Explain why there was no distribution to investors in year two.

Question 5 continued on the next page.

5. Continued

- (d) (2.5 points) SPV investors are unhappy with the capital position of the SPV at the end of year two.

The Head of Capital Management has sent you an e-mail containing the following arguments and recommendation:

- Since the SPV is a separate legal entity, OSZ has no legal obligation to transfer additional capital.
- Transferring OSZ's capital to the SPV would have a negative impact on earnings and thus is not in the best interest of their shareholders.
- Allowing the SPV to default could impact OSZ's ability to access capital markets for future projects, which would have a negative long term impact.
- Recommendation: OSZ should make a one-time transfer of 1,000,000 ACU to the SPV, contingent on the investors agreeing to the following restructuring:
 - Distributions to investors will be changed from the excess of capital over 125% of required capital to the excess of capital over 250% of required capital
 - No future transfers of capital from OSZ to the SPV will occur under any circumstances.

Critique each of the arguments and the recommendation.

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6. (9 points) You are the CRO for JKL, a health insurance company. JKL is looking to diversify its risk exposure through strategic acquisition. The company is evaluating the purchase of a closed block of variable annuities (VA) from LifeCo, a life insurance company.

(a) (2 points) You have asked your actuarial student to assist with developing a risk register for the VA block. Your student wants to organize a survey to complete the risk register based on the responses of the current staff.

- (i) Identify two key limitations generally associated with the survey approach.
- (ii) After discussing the limitations with surveys with your student, you recommended the Independent Group Analysis technique as an alternative to conducting a survey.

Explain how this recommendation addresses both limitations you identified in (i).

(b) (3.5 points) JKL’s CEO has hired a consultant to analyze the capital market risks embedded within the VA block. The consultant’s report included capital market correlations shown in the table below.

Capital Market Correlations

Asset Class	Sector		1	2	3	4
Fixed Income	US High Yield Bonds	1	1.0	0.8	0.7	0.3
Equity	US Large Cap	2	0.8	1.0	0.9	-0.6
Equity	Euro Large Cap	3	0.7	0.9	1.0	0.1
Alternatives	US Commodities	4	0.3	-0.6	0.1	1.0

The CEO has asked you to present on the capital markets modeling for the VA block. Your presentation will be to the Board of Directors (BoD).

Your actuarial student feels that the correlation matrix in the consultant’s report is too detailed for the BoD and wants to present this information as an influence matrix instead. The student identified the following qualitative observations about capital markets:

- Equity markets influence the fixed income markets
- Fixed income markets influence alternatives
- Alternatives influence equity markets
- Each sector influences the other sectors within the same asset class

6. Continued

Your student rounded all correlations to the nearest 0.5 for credibility (for example, 0.3 is rounded to 0.5) and has started populating the influence matrix as provided below.

Asset Class	Sector		1	2	3	4
<i>Fixed Income</i>	<i>US High Yield Bonds</i>	1	N/A		0	
<i>Equity</i>	<i>US Large Cap</i>	2		N/A		
<i>Equity</i>	<i>Euro Large Cap</i>	3	1		N/A	
<i>Alternatives</i>	<i>US Commodities</i>	4				N/A

- (i) Determine the missing values (0, 1, or 2) in each cell. Show your work.
- (ii) Identify two sectors that will require direct risk mitigation based on the influence matrix. Justify your response.
- (c) (2 points) You are concerned that the consultant did not mention any VA operational risks in the risk report. You have identified the following key VA operational risks in the risk register:
- Regulatory risk
 - Technology risk
 - Process risk
 - Reputational risk
- (i) Evaluate whether the scenario planning approach is an appropriate risk management strategy for each operational risk identified.
- (ii) Recommend an alternative risk management strategy for each risk. Support your recommendation.

Question 6 continued on the next page.

6. Continued

- (d) *(1.5 points)* Several months have passed, and risk management strategies have been implemented for the operational risks. The consultant has assisted JKL in engaging an investment bank to assist with hedging the capital markets risks embedded within the VA block.

The BoD has scheduled a meeting for next week to review the proposed purchase and make a decision whether or not to purchase the VA block. They would like to review your risk analysis at that meeting.

Assess whether the influence matrix can help support your recommendation. Justify your response.

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**Questions 7 and 8 pertain to the Case Study and/or extension readings.
Each question should be answered independently**

7. (9 points)

- (a) (2.5 points) Propose, for each of the situations below, a type of reinsurance that AHA could use to address the situation. Justify your response.
- I. AHA has decided to pursue both the Eureka and Columbia acquisitions but does not have enough excess capital to acquire both companies.
 - II. Due to new regulations at the group level and the exposure at SLIC, Lyon is requiring AHA to limit its potential losses in the event of a severe pandemic.
 - III. New regulations require coverage of treatment at specialty mental health centers, an area where AHA has limited expertise.

AHA is considering reinsurance to help mitigate its insurance risks on its Kentucky (KY) and South Carolina (SC) Total Group Medical blocks. AHA received a quote for quota share coinsurance for the blocks starting on 1/1/2019.

Reinsurance contract for KY:

- Quota Share – 30% to be ceded to reinsurer
- The reinsurer pays an allowance equal to 16.5% of premium ceded minus \$3.00 Per Member Per Month for KY.

Reinsurance contract for SC:

- Quota Share – 20% to be ceded to reinsurer
- The reinsurer pays an allowance equal to 16.5% of premium ceded minus \$2.50 Per Member Per Month for SC.

Assume the following:

- Expenses for these blocks are 16.5% of premiums in all years.
- 0% trend.

7. Continued

- (b) (2 points) Calculate the following amounts ceded and retained by AHA for each of KY and SC, assuming the reinsurance contracts had been in place during 2017.
- I. Premiums
 - II. Claims
- (c) (3.5 points) Calculate the impact the reinsurance contracts would have on the 2017 net income for each of KY and SC, assuming the contracts had been in place during 2017. Show your work.
- (d) (1 point) Explain why reinsurance might still be considered even if the reinsurance contract reduces net income for the ceding company.

*Questions 7 and 8 pertain to the Case Study and/or extension readings.
Each question should be answered independently*

- 8.** (11 points) AHA is looking for growth opportunities overseas. One proposal AHA is considering is offering a new plan in Atlantis.

Atlantis has a single health insurance exchange under which all citizens are eligible to receive coverage. Member premiums may be as low as \$0/month, depending on the plan chosen.

In addition to member premiums, any insurance company offering coverage on the health insurance exchange receives premium revenue from the government. The premium revenue from the government is based on a risk equalization mechanism.

Each citizen of Atlantis is assigned one of sixteen unique Risk Factors (Risk Factor_{*j*}), ranging from 0.50 to 2.00 and calculated based on the individual's health risk characteristics (Risk Factor₁ equals 0.50, Risk Factor₂ equals 0.60, etc.) These factors were developed by the government in 2005.

The premium revenue that an insurance company receives for each covered individual is calculated by the formula:

$$\text{Monthly Premium Revenue} = \text{Risk Factor}_j * \$375 / \text{month}$$

PoseidonCare is currently the only insurance company offering plans on the exchange.

For a PoseidonCare plan offering standard plan benefits, AHA estimates the following:

- Average Monthly Member Premium = \$30
 - Expected Annual Claim Cost for a Member with Risk Factor_{*j*}
= $\$2100 \times (\text{Risk Factor}_j)^2 + \$200 \times \text{Risk Factor}_j + \1500
 - Administrative Expenses = 15% of claims
- (a) (5 points) AHA wants to offer a new plan with benefits similar to PoseidonCare and is evaluating the risk associated with this opportunity.
- (i) Define risk selection in the context of health insurers and consumers.
 - (ii) Describe how a health insurer may act on the risk selection incentive. Give specific examples in the individual health insurance marketplace.
 - (iii) Calculate the Risk Factor above which a health insurer in Atlantis may be incentivized to take undertake risk selection actions.

8. Continued

- (b) (4 points) AHA's New Markets team notes that for Triangle City, a rating area within Atlantis, PoseidonCare offers only one health plan with relatively lean benefits and a member premium of \$10/month. The team suggested that if AHA were to enter the market and offer a plan with rich benefits to differentiate itself from PoseidonCare, there would be a significant membership growth opportunity to capture a sizable slice of the market.
- (i) Identify and describe three major risks that AHA should consider if it wants to enter the market with a benefit-rich plan.
 - (ii) Suggest a unique strategy for each of the risks described in sub-part (i) that AHA can adopt to mitigate the risk.
- (c) (2 points) Upon learning of AHA's interest in Atlantis, the Atlantis health insurance regulator has offered to meet with AHA to discuss the current market issues/problems.

Identify and describe three improvements that AHA could suggest to improve overall market competitiveness and reduce risk selection incentives.

****END OF EXAMINATION****

USE THIS PAGE FOR YOUR SCRATCH WORK