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# Accredited Financial Examiner

## SOFE AFE

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QUESTION NO: 1

Final approval should be obtained prior to placing a new system into operation is the activity that can be fall into which control?

**A.** Organizations and operations control

**B.** System development control

**C.** Access control

**D.** Procedural control

**ANSWER: B**

**Explanation:**

**System development control** is correct because final approval before a newly developed or acquired system enters production is a formal system-development-life-cycle control. It provides a documented management decision that the implementation has completed required development, testing, user acceptance, security review, conversion, and readiness activities. This approval establishes accountability for accepting the system and confirms that it is suitable for operational use before live processing begins. For financial-examination purposes, the control also creates an audit trail showing that management authorized the transition from development to production and that significant implementation risks were considered before the system could affect business records, reporting, or customer services.

NIST describes authorization and security assessment activities as lifecycle requirements that must occur before a system is placed into operation, with the authorization decision based on assessed risk and documented evidence. Its System Development Life Cycle guidance likewise treats implementation and deployment as controlled stages requiring review and approval rather than an informal technical release. These principles support classifying pre-production final approval as a system development control. See NIST SP 800-64 Rev. 2, Security Considerations in the System Development Life Cycle and NIST SP 800-37 Rev. 2, Risk Management Framework.

**QUESTION NO: 2**

In reviewing a retained asset account program, an examiner should determine whether the insurer:

**A.** Provides the beneficiary with required disclosures concerning the account

**B.** Permits the beneficiary to obtain the full account balance under the account terms

**C.** Reconciles account balances to the related policyholder liability

**D.** Transfers investment ownership of the account assets to each beneficiary

**ANSWER: A B C**

**Explanation:**

Disclosure of the account terms, availability of the full proceeds to the beneficiary, and reconciliation of account balances to the related liability are appropriate examination considerations. A retained asset account is a settlement mechanism under which proceeds remain with the insurer in an interest-bearing account for the beneficiary. The beneficiary's ability to obtain the proceeds, the interest-crediting terms, and any conditions governing drafts or withdrawals should be clearly disclosed.

Because the funds remain an obligation of the insurer until withdrawn or otherwise paid, account balances must be supported by complete records and reconciled to the liability reported in the insurer's financial statements. Investment of the retained asset account balances in the beneficiary's name is not required; the insurer generally retains the investment responsibility while owing the account balance to the beneficiary. See NAIC Model Regulation 680.

**QUESTION NO: 3**

A deferred annuity is distinguished from an immediate annuity primarily because income payments under a deferred annuity:

**A.** Begin at a future date

**B.** Must be made only as a lump sum

**C.** Cannot involve life contingencies

**D.** Are payable only to more than one annuitant

**ANSWER: A**

**Explanation:**

Begin at a future date is correct because a deferred annuity has an accumulation period before annuitization or other payment commencement. During this period, premiums or deposits accumulate under the contract's credited-interest, investment-performance, or other provisions. The annuity payments begin later, commonly at retirement or another contractually selected date.

An immediate annuity, in contrast, is generally purchased with a single premium and begins making periodic income payments shortly after purchase. Both forms can provide life-contingent or period-certain payment arrangements, but the timing of the commencement of income payments is the basic distinction. See the NAIC overview of annuities.

**QUESTION NO: 4**

What is based on statistical data and are large groups of similar risks can be classified by a few and easily identifiable characteristics and result in standard rates?

**A.** Numerical rating

**B.** Premium rating

**C.** Manual rating

**D.** Item rating

**ANSWER: C**

**Explanation:**

Manual rating is correct. It is a standardized insurance-rating method that relies on accumulated statistical experience for a broad class of substantially similar exposures. The insurer groups risks using a limited set of readily observable, measurable characteristics—such as classification, territory, construction, or limits—and applies rates published in an underwriting or rating manual. Because the risks in each class are sufficiently homogeneous, their historical loss and exposure data can be aggregated to develop prospective, standard rates that can be applied consistently to individual insureds in that class.

This method supports efficient and repeatable premium determination where there is a large enough body of comparable risks to produce credible statistical results. Rating manuals commonly contain the classifications, base rates, rules, and adjustments needed to translate an insured’s characteristics into the applicable premium. The National Association of Insurance Commissioners describes rate standards and the use of actuarial data in insurance regulation at https://content.naic.org/insurance-topics/property-casualty-insurance. Further background on insurance ratemaking principles and statistical support for rates is available from the Casualty Actuarial Society at https://www.casact.org/.

**QUESTION NO: 5**

A mortgage servicer performs all of the servicing functions. The servicer remits all funds received on the serviced loans to the company on a monthly or other periodic basis and usually reports all transactions, including foreclosures and transactions related to foreclosed property. The contract between the company and servicer should provide that the:

**A.** Company can periodically audit the servicer’s records and files pertaining to the loans owned by the company. In lieu of making the audit, the company can agree to receive an annual audit report pertaining to its loans from the servicer’s independent certified public accountants. This is the single audit concept

**B.** Servicer should not have a fidelity bond and an errors and omission policy of stipulated minimum amounts

**C.** Servicer must have a fidelity bond and an errors and omission policy of stipulated minimum amounts

**D.** Servicer must have an annual independent audit, with a copy of the audited financial statements sent to the company within a certain period of time after the end of the servicer's fiscal year

**ANSWER: A C D**

**Explanation:**

The contract should preserve the company's ability to oversee the servicer and obtain reliable evidence that loan collections, escrow activity, foreclosure reporting, and related records are being handled appropriately. Permitting the company to audit servicing records and loan files is a direct control over assets and reporting. Accepting an annual independent accountant's report in lieu of a company-performed audit may also provide assurance across the serviced-loan population under the stated single-audit arrangement.

Requiring fidelity coverage and errors-and-omissions insurance protects the company against losses arising from dishonest acts, employee misconduct, processing failures, and professional servicing errors. Specifying minimum coverage amounts makes this protection measurable and enforceable rather than discretionary. The contract should also require an annual independent audit and timely delivery of the servicer's audited financial statements. Those statements provide important evidence of the servicer's financial condition and its continuing capacity to perform its obligations, while the audit requirement supports the company's ongoing vendor-governance and monitoring responsibilities.

These provisions align with the expectation that servicers maintain policies and procedures reasonably designed to support compliant servicing operations under 12 CFR 1024.38. They are also consistent with the Consumer Financial Protection Bureau's emphasis on effective oversight when mortgage-servicing responsibilities are transferred or managed through third parties; see CFPB Bulletin 2013-01.

**QUESTION NO: 6**

The methods used for the premium rates establishment are:

**A.** Manual, judgmental and premium rating

**B.** Commercial, judgmental and merit rating

**C.** Manual, experimental and merit rating

**D.** Manual, judgmental and merit rating

**ANSWER: D**

**Explanation:**

Manual, judgmental and merit rating are the recognized methods used to establish insurance premium rates. Manual rating applies filed or published rate manuals to defined classifications and exposure units, promoting consistent treatment of similar risks. The rate manual is ordinarily supported by actuarial analysis of expected losses, expenses, and required provisions for contingencies or profit. Judgmental rating is used where a risk's particular characteristics, limited experience, or unusual exposures require an underwriter to exercise informed professional judgment in setting an appropriate premium. Merit rating then adjusts the otherwise applicable premium to reflect the individual insured's loss experience, claims record, or other measurable risk characteristics. In practice, these approaches allow insurers to begin with a consistent technical rate structure, address risks that do not fit neatly into standard classifications, and recognize demonstrated differences in loss potential among insureds. This distinction is central to financial examination because rating practices affect premium adequacy, underwriting results, and the reliability of reported financial performance. The Society of Financial Examiners identifies insurance regulation and examination as core professional subject matter; see SOFE. For insurance-rate terminology and actuarial context, see the Insurance Information Institute's overview of insurance principles and practices.

**QUESTION NO: 7**

Which of the following is NOT the kind of public entity risk pools?

**A.** risk-avoiding pools

**B.** insurance-purchasing pools

**C.** banking pools

**D.** claim-serving pools

**ANSWER: A**

**Explanation:**

**risk-avoiding pools** is the correct response. Public-entity risk pooling is a cooperative risk-financing mechanism through which governmental entities combine resources, administrative functions, or insurance purchasing power to address common exposures. The recognized functional descriptions of such arrangements include insurance-purchasing pools, claims-servicing pools, banking pools, and risk-sharing or risk-assumption pools. A pool therefore helps members finance, administer, transfer, or share risk; it is not classified as a "risk-avoiding" pool. Risk avoidance is instead a risk-management technique in which an organization elects not to undertake an activity or exposure in the first place. It describes an individual entity's treatment of risk, rather than an organizational form through which public entities pool risk. This distinction is important to financial examiners because the pool's structure determines how premiums or contributions, reserves, claims administration, insurance procurement, and member obligations are evaluated. Public-entity pooling statutes and regulatory frameworks address the pooling and financing of risks, including self-insurance and joint insurance arrangements. See the NAIC's Public Entity Risk Pooling Act model and California Government Code Section 990.4 for examples of the statutory treatment of public-entity risk-pooling arrangements.

**QUESTION NO: 8**

The contracts that are not subject to unilateral changes in its provision and requires the performance of various functions and services for an extended period is called:

**A.** Short-duration

**B.** Long-duration

**C.** Medium-duration

**D.** Fixed-duration

**ANSWER: B**

**Explanation:**

Long-duration is correct because the defining economic characteristic is an insurer's continuing obligation to provide benefits, administer the contract, and perform related services over a substantial period. These contracts generally establish terms at issue that are not routinely subject to unilateral revision by the insurer, so their accounting requires estimates that reflect long-term assumptions and expected future cash flows. In insurance financial reporting, long-duration contracts commonly encompass products such as life insurance, annuities, and certain disability contracts, for which the insurer's performance obligation can extend for many years. This contrasts with contracts whose coverage and pricing are ordinarily reassessed over relatively brief policy periods. The description in the question emphasizes both the inability to make unilateral provision changes and the extended performance period, which directly identifies a long-duration contract. This classification is important to financial examiners because it affects how reserves, policy benefits, assumptions, and related disclosures are evaluated in statutory and GAAP-based reporting. The Financial Accounting Standards Board's long-duration insurance-contract guidance discusses accounting improvements for these long-term obligations; see FASB Accounting Standards Update 2018-12. Additional insurance-accounting context is available from the National Association of Insurance Commissioners.

**QUESTION NO: 9**

Effective controls over a mortgage servicer's escrow account include:

**A.** Maintaining a separate escrow or trust bank account

**B.** Reconciling bank balances, escrow records, and related liabilities periodically

**C.** Requiring support and authorization for escrow disbursements

**D.** Using excess escrow receipts to pay the servicer's operating expenses

**ANSWER: A B C**

**Explanation:**

A separate escrow or trust account, periodic reconciliation, and controlled authorization of disbursements are appropriate controls. Escrow funds are held for borrowers or other parties and must be safeguarded separately from the servicer's own operating funds. Regular reconciliation of bank balances, subsidiary records, and escrow liabilities helps identify errors, shortages, and unrecorded transactions promptly.

Disbursements for taxes, insurance, or other authorized purposes should be supported by documentation and approved under established procedures. Using escrow balances to pay the servicer's general operating expenses would constitute improper commingling and misuse of funds. Federal servicing rules address escrow-account administration in 12 CFR § 1024.17.

**QUESTION NO: 10**

What may leave more risk than a company should prudently assume due to the risk exacerbating features of a particular product?

**A.** Feasible investment strategy

**B.** Design strategy

**C.** Risk strategy

**D.** Product risk strategy

**ANSWER: A**

**Explanation:**

Feasible investment strategy is correct. In insurance financial examination and enterprise-risk-management practice, a strategy can be feasible in the practical sense that assets are available, the investments can be purchased and administered, and the anticipated cash flows can support the product. That feasibility alone does not establish that the resulting risk position is prudent. A product may contain features that amplify exposure to interest-rate changes, liquidity demands, market movements, policyholder behavior, embedded guarantees, or asset-liability mismatches. Those features can leave the insurer with residual risk beyond its established risk appetite even when the investment approach is operationally achievable.

Accordingly, management must evaluate investment feasibility together with the product's risk profile, capital position, liquidity needs, and ability to withstand adverse scenarios. This reflects the own-risk-and-solvency-assessment principle that insurers assess material risks prospectively and determine whether available capital is adequate for those risks. It also aligns with supervisory expectations that insurers maintain investment-risk-management processes appropriate to the nature, scale, and complexity of their operations. See the NAIC's Own Risk and Solvency Assessment Guidance Manual and the NAIC Financial Condition Examiners Handbook.

**QUESTION NO: 11**

When an insurer holds a mortgage loan secured by income-producing property, ongoing loan surveillance may include:

**A.** Updated property operating statements

**B.** Periodic property inspections

**C.** Review of real estate tax and insurance status

**D.** Reliance only on the appraisal obtained at origination

**ANSWER: A B C**

**Explanation:**

Updated operating statements, inspections of the property, and review of taxes and insurance are appropriate surveillance procedures. Operating statements provide evidence concerning rental income, expenses, occupancy, net operating income, and debt-service capacity. Inspections may identify physical deterioration, deferred maintenance, construction issues, or other conditions that could impair value. Verification of tax and insurance status helps protect the lender's collateral interest and identifies possible liens, uninsured losses, or covenant violations.

A lender should not rely indefinitely on underwriting information obtained at origination. Continuing surveillance is necessary because the borrower's financial condition and the property's income-producing ability can change during the loan term. See the FDIC real estate lending standards.

## QUESTION NO: 12

Direct serving loans method requires a system of good internal control and requires that the functions be split between the Accounting Department and the Investment Department. The Investment Department is responsible for promptly supplying the Accounting Department with:

**A.** Accounting data on new loans

**B.** Resolving few exceptions reported to it by the Accounting Department, i.e., when a borrower defaults on a loan payment

**C.** Data related to changes in existing loans, which affects the accounting function

**D.** Alerting the Investment Department promptly whenever an exception to the normal processing routine occurs

**ANSWER: A C**

**Explanation:**

In a direct-servicing loan operation, effective segregation of duties depends on a timely, documented flow of loan-transaction information from the Investment Department to the Accounting Department. "Accounting data on new loans" is required so that the accounting records can recognize the new investment accurately, establish the related receivable or asset balance, and begin the appropriate income-accrual and reporting processes. "Data related to changes in existing loans, which affects the accounting function" is also required because modifications to principal balances, interest rates, payment terms, collateral, maturity dates, or other servicing terms can change recorded balances, accrued investment income, valuation, and financial-statement reporting. Providing this information promptly enables accounting personnel to record transactions independently from the personnel responsible for investment and servicing decisions. That separation creates an audit trail and supports reconciliations between servicing records and the general ledger, which are core features of sound internal control. The COSO internal-control framework emphasizes reliable information, communication, and control activities, including appropriate assignment and segregation of responsibilities. Insurance-company statutory reporting is likewise governed by NAIC accounting and reporting requirements, making complete and timely investment data essential to accurate records. See COSO's Internal Control guidance and the NAIC Financial Reporting resources.

## QUESTION NO: 13

Loans on policies are valuable to the policyholders, and insurers encourage them to protect this feature by saving it for emergency use. There are two basic types of loans. In case of conventional premium loans:

**A.** The insured makes a request for a loan. Since an emergency may very well have triggered this request, most companies will accept any form of notice such as a telephone call

**B.** The maximum loan amount is frequently limited to the cash value of the policy plus the value of paid-up additions

**C.** an insured has indicated in the insurance application that the policy is not to lapse for nonpayment of premiums so long as there is loan value adequate to cover unpaid premiums

**D.** Loan can be created to pay policy loan interest if the policyholder-borrower does not pay it in cash

**ANSWER: A B**

**Explanation:**

For conventional premium loans, the policyholder initiates the transaction by requesting an advance against the policy's available loan value. Because a need for funds can be urgent, insurers commonly provide practical methods for receiving and processing a loan request, including telephone-based contact where the insurer's procedures and authorization requirements permit it. The essential feature is that the loan is affirmatively requested by the insured or policyowner rather than being triggered automatically.

The amount available is tied to the policy's accumulated value. In participating life insurance, paid-up additions increase the policy's value and therefore can increase the amount that may be borrowed. Accordingly, a loan limit commonly reflects the policy cash value together with the value attributable to paid-up additions, subject to the insurer's contractual calculation, any existing indebtedness, accrued interest, and applicable policy limits. This connection between policy value and loan availability preserves the insurer's collateral position: the policy's value secures the advance. State life-insurance loan provisions generally require policies to provide loans on the security of the policy's cash value and address the treatment of indebtedness and interest. See, for example, Maine Revised Statutes, Title 24-A §2537 and the NAIC consumer guidance on life insurance.

**QUESTION NO: 14**

Federal Housing Administration:

**A.** Agency does not make loans; it only insures them. For this protection the borrower must pay an annual insurance premium to the FHA of 0.5 percent of the outstanding principal amount of the loan

**B.** Agency does not make loans; upon default, the lender has the option either of assigning the mortgage to the FHA and receiving cash and/or securities equal to the loan amount at the date of the default or of foreclosing on the mortgaged property

**C.** Establishes standards for property that can not be insured and maximum terms, interest rates, and amounts for the insured loans

**D.** All of these

**ANSWER: A B**

**Explanation:**

The statements "Agency does not make loans; it only insures them. For this protection the borrower must pay an annual insurance premium to the FHA of 0.5 percent of the outstanding principal amount of the loan" and "Agency does not make loans; upon default, the lender has the option either of assigning the mortgage to the FHA and receiving cash and/or securities equal to the loan amount at the date of the default or of foreclosing on the mortgaged property" correctly describe the FHA's fundamental historical mortgage-insurance role. FHA is not a direct mortgage lender. Instead, approved private lenders originate FHA-insured mortgages, while the insurance protects the lender against losses caused by borrower default. Borrowers fund that protection through mortgage insurance premiums; the precise annual premium rate has varied over time and by loan characteristics, but the stated percentage reflects the traditional exam-oriented description of the program. When an insured mortgage defaults, FHA insurance claim procedures allow a mortgagee to pursue remedies that include assignment of the mortgage or foreclosure and conveyance of the property, subject to program requirements. These mechanisms transfer qualifying insured loss exposure from the originating lender to the FHA insurance fund and support lenders' willingness to offer mortgages with FHA program terms. See HUD's overview of FHA mortgage insurance and HUD's Single Family Housing Policy Handbook for FHA-insured mortgage and claim-policy information.

## QUESTION NO: 15

Experience refund provisions of group insurance contracts are most often concerned with the manner of distributing any profits between the insurer and the insured group. The agreements usually contain provisions specifying how losses will affect the profit allocations for the insured group. In such situation:

**A.** Losses may or may not be charged back

**B.** Losses can never be charged back

**C.** Gains are distributed according to the agreement between both the parties

**D.** If charged back, losses for each group are usually accumulated for a certain number of years

## ANSWER: A D

**Explanation:**

“Losses may or may not be charged back” is correct because an experience-refund arrangement is governed by the terms of the particular group insurance contract. The contract’s experience-rating formula defines the extent to which unfavorable claims experience reduces, eliminates, or is carried forward against a group’s otherwise available experience refund. A chargeback is therefore a contractual mechanism rather than an automatic consequence of a loss.

“If charged back, losses for each group are usually accumulated for a certain number of years” is also correct. Experience-rating and refund arrangements commonly use a stated experience period and may retain deficit balances for later periods. Accumulating a group’s losses over a defined carry-forward period permits the insurer to offset future favorable experience before paying a refund, helping ensure that refunds reflect the group’s longer-term claims and expense experience rather than a single favorable year. The number of years, eligible experience, and any limits on the deficit carry-forward must be specified in the governing agreement and applied consistently.

This treatment is consistent with actuarial practice for group insurance, which requires appropriate consideration of experience, benefits, expenses, and contractual provisions when determining costs or financial values. See the Actuarial Standards Board’s Group and Health Insurance standard and the NAIC’s Financial Condition Examiners Handbook.

## QUESTION NO: 16

When dividends are left to accumulate at interest, the insurer typically sends a notice to each policyholder showing the amount accumulated at the end of the policy year. The notice also shows the dividend credited and interest earned for that policy year. The dividend left at interest may later be received by or credited to the policyholder in several ways. Which of the following is/are out of those ways?

**A.** As a cash withdrawal.

**B.** As premium applied to the purchase by the policyholder of paid-up insurance.

**C.** As marketable securities

**D.** As premium to pay up or mature the policy.

## ANSWER: A B D

**Explanation:**

Dividends accumulated at interest are amounts held by the insurer for the policyholder under a participating life-insurance policy. The accumulated balance, including credited interest, remains available for policyholder-directed uses under the policy’s dividend provisions. “As a cash withdrawal” is a standard disposition because the policyholder may withdraw the accumulated dividend value. “As premium applied to the purchase by the policyholder of paid-up insurance” is also an established use: dividend values can purchase paid-up additional insurance, increasing the policy’s permanent insurance amount without further out-of-pocket premium. “As premium to pay up or mature the policy” is likewise a recognized application of accumulated values, because they may be applied toward premiums or used as part of the value available when the policy becomes paid up or reaches maturity. These treatments reflect the fundamental principle that declared dividends and credited interest belong to the policyholder subject to the contract terms and are accounted for as policy

obligations until paid or applied. Statutory life-policy provisions commonly identify cash payment, premium payment, paid-up additions, and accumulation at interest as permissible dividend options; see California Insurance Code § 10171 and the NAIC Life Insurance Buyer's Guide.

## QUESTION NO: 17

Schedule H retains the identity of the Group Accident and Health and the Credit Accident and Health lines of business. However, in Schedule H the line of business designated as Other Accident and Health is subdivided to identify individual policies or elective options. Which of the following is/are out of those classifications?

**A.** Collectively Renewable

**B.** Cancelable

**C.** Guaranteed renewable

**D.** Non-renewable for market reasons only

## ANSWER: A C

**Explanation:**

"Collectively Renewable" and "Guaranteed renewable" are classifications used for the individual-policy or elective-option detail within the Other Accident and Health business reported on Schedule H. These classifications identify the renewal characteristic attached to the coverage, which is material when presenting accident-and-health experience because the insurer's continuing obligation and ability to alter or terminate coverage can differ by renewal provision. Guaranteed renewable coverage generally requires the insurer to continue renewing the policy, subject to stated conditions, although premiums may be changed on a class basis. Collectively renewable coverage reflects coverage whose renewal is determined collectively for a defined class or arrangement rather than through an insurer decision based on an individual insured's experience. Reporting these categories separately supports consistent statutory reporting and enables regulators to evaluate business with differing policyholder protections and risk characteristics. Schedule H's detailed accident-and-health reporting is part of the NAIC annual-statement reporting framework and should be completed according to the applicable annual-statement instructions. See the NAIC's financial reporting resources and its Annual Statement Instructions information for the governing reporting framework and instructions.

## QUESTION NO: 18

What are designed primarily to accumulate a fund for eventual liquidation via annuitization, so the savings element is predominant?

**A.** Variable annuities

**B.** Deferred annuities

**C.** Immediate annuities

**D.** None of the above

## ANSWER: B

**Explanation:**

Deferred annuities are designed chiefly for the accumulation period: premiums are paid into the contract and the contract value grows on a tax-deferred basis until a later date selected for withdrawals, income payments, or conversion to an annuity payout stream. Because income payments do not ordinarily begin immediately, the contract's central purpose during this phase is building a fund. This is why the savings element is predominant. At the end of the deferral period, the owner may elect annuitization, which converts the accumulated value into a structured series of payments under the contract's available settlement options. The National Association of Insurance Commissioners describes deferred annuities as products in which payments begin at a future date and notes that annuities can be used to accumulate funds for retirement or other long-term objectives. This distinction between accumulation and later liquidation through annuitization is fundamental to classifying an

annuity as deferred. See the NAIC's consumer overview of annuities and the IRS guidance on annuity distributions and retirement income.

## QUESTION NO: 19

Adjusting and Others (AO) reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for Inflation in Defense & Cost Containment (DCC) reserves.

**A.** True

**B.** False

## ANSWER: A

**Explanation:**

**True** is correct. Adjusting and Other expense reserves commonly reflect claim-adjustment costs that are closely tied to the insurer's aggregate claims-handling activity during a reporting period. A calendar-year paid-to-paid approach therefore provides a practical basis for estimating the needed provision: it compares the current period's paid adjusting and other expenses with the prior period's paid amounts, then applies the resulting relationship to the relevant projected payment base. This approach is particularly useful where expense payments cannot be reliably or consistently assigned to individual accident years, or where the timing of expense processing differs from the timing of underlying loss payments.

Inflation provisions for Defense and Cost Containment expenses, in contrast, are generally evaluated on an accident-year paid-to-paid basis so that the observed change measures the development of costs for comparable accident-year claim populations. Aligning the paid amounts by accident year helps isolate inflationary change from shifts in claim mix or reporting-year operational activity. The distinction reflects the different data relationships underlying these two reserve provisions and is consistent with statutory reserving analysis of loss-adjustment expenses. The NAIC's statutory reporting resources are available at NAIC Financial Statement Filing, and the CAS provides terminology for defense and cost-containment expense at CAS DCCE Glossary.

## QUESTION NO: 20

_____ reserves for income tax purposes are referred to as maximum tax actuarial reserves (MTAR) and replace the actuarial liabilities used for accounting purposes in computing taxable income.

**A.** Procedure-related

**B.** Policy-related

**C.** Standardized- related act

**D.** None of the above

## ANSWER: B

**Explanation:**

**Policy-related** is correct because maximum tax actuarial reserves (MTAR) are the tax-basis reserves associated with the insurer's obligations under its insurance policies. For life-insurance-company federal income-tax reporting, the reserve deduction is determined under tax-specific rules rather than by simply carrying over actuarial liabilities calculated for statutory or financial-accounting reporting. MTAR therefore represents the maximum reserve amount permitted for a policy-related liability when taxable income is computed.

This distinction is important to financial examiners because policy reserves are fundamental measures of obligations to policyholders, but their accounting valuation and their federal tax valuation can be governed by different objectives and prescribed methods. Financial-statement actuarial liabilities are intended to report obligations under the applicable accounting framework, while tax reserves are calculated under Internal Revenue Code requirements designed for taxable-income measurement. Internal Revenue Code § 807 addresses the treatment and computation of life-insurance reserves for

federal tax purposes, including the statutory framework for determining the amount taken into account as reserves. See 26 U.S.C. § 807 and the IRS's Instructions for Form 1120-L.

## QUESTION NO: 21

A Company's investments are admitted assets properly valued which support the reserves and liabilities, including required capital and surplus. Many jurisdictions permit companies to make some investments that do not meet all of the strict regulatory requirements. These additional investments are often referred to as basket assets. Which of the following is/are true for Basket assets?

**A.** They have been made out of a company's free surplus

**B.** Mortgage loans are first liens on the property backing them. Second or third-lien mortgages typically qualify as "basket" loans

**C.** A particular entity can obtain this benefit

**D.** They record investment and number of mortgages on which interest has been reduced, and the percent the interest was reduced

## ANSWER: A B

**Explanation:**

Basket-asset authority gives an insurer limited flexibility to hold investments that fall outside the ordinary, category-specific investment rules, while preserving the protection afforded by capital, surplus, and investment limits. These investments are generally made from free surplus: surplus in excess of the amount needed to support required reserves, liabilities, and minimum capital. The amount that may be committed is normally subject to an aggregate percentage limit and other conditions imposed by the insurer's domiciliary jurisdiction. Thus, the insurer uses surplus available beyond required financial support rather than assets needed to secure policyholder obligations.

The statement regarding mortgage liens correctly reflects a common application of basket treatment. Insurance investment statutes commonly authorize first-lien mortgage loans under their regular mortgage-investment provisions because the insurer has the senior secured claim against the property. A junior mortgage, such as a second- or third-lien loan, has greater credit and recovery risk because senior lienholders are paid first upon foreclosure or liquidation. Subject to the applicable jurisdiction's limits and conditions, that additional risk may cause such loans to be held under basket authority. State insurance investment statutes establish these classifications and quantitative limits; see the New York Insurance Law investment provisions and the NAIC's Financial Regulation resources.

## QUESTION NO: 22

Effective internal control over cash receipts in a mortgage-loan servicing operation includes:

**A.** Reconciling receipts, servicing records, and bank deposits on a timely basis

**B.** Independent review of bank-account reconciliations

**C.** Reviewing exception reports for unapplied or unusual cash activity

**D.** Allowing one employee to receive cash, change loan balances, and reconcile the bank account without review

## ANSWER: A B C

**Explanation:**

Cash receipts should be controlled independently from the personnel responsible for authorizing loan modifications, approving investments, or maintaining the borrower relationship. Daily or timely reconciliation of cash receipts to servicing records and bank deposits helps identify missing deposits, posting errors, and unauthorized activity. Independent review of bank-account reconciliations provides an additional control over the completeness and accuracy of recorded cash. Exception

reports for unapplied cash, reversals, delinquent payments, and other unusual transactions help management identify items requiring prompt investigation.

Allowing the same employee to receive borrower payments, alter loan balances, and complete bank reconciliations without independent review creates incompatible duties and materially increases the opportunity to conceal errors or misappropriation. The COSO framework identifies control activities, segregation of duties, and reliable information as important components of effective internal control. See COSO Internal Control guidance.

## QUESTION NO: 23

An increase in loss reserves may lead to offset by a reduction in premiums and a decrease in loss reserves may be a receivable for additional premiums.

**A.** True

**B.** False

## ANSWER: B

**Explanation:**

**False** is correct. In a retrospectively rated or other loss-sensitive insurance arrangement, premium is ultimately adjusted to reflect the insured's actual or estimated loss experience, subject to the contract's stated limits and rating formula. Loss reserves are estimates of unpaid losses and loss-adjustment expenses. When estimated ultimate losses—and therefore the related reserves—increase, the estimated retrospective premium generally increases as well. The insurer may then recognize an additional premium receivable, provided that collection is reasonably assured and the applicable accounting requirements are met. Conversely, a decline in estimated loss reserves generally reduces the estimated premium; depending on the contract's terms and amounts already billed or collected, this can create a premium reduction, return premium, or payable to the policyholder. Thus, the relationship described in the statement is reversed. This treatment follows the core retrospective-rating concept that the final premium is based on incurred losses rather than solely on the original provisional premium. The NAIC's statutory accounting guidance for retrospectively rated contracts addresses recognition of estimated premium adjustments associated with changes in loss estimates. See the NAIC SSAP No. 66, Retrospectively Rated Contracts and the IRMI definition of retrospective rating.

## QUESTION NO: 24

In administering a construction mortgage loan, sound controls over periodic advances include:

**A.** Periodic inspections of completed work

**B.** Documentation supporting construction costs and disbursements

**C.** Updated analysis of the cost to complete the project

**D.** Advancing the full commitment at closing regardless of construction progress

## ANSWER: A B C

**Explanation:**

Construction lending requires controls that connect each advance to the actual condition and cost of the project. Periodic inspections provide evidence that work has been completed and that the collateral is progressing as expected. Lien waivers, invoices, and other contractor documentation help establish that prior advances have been used for construction costs and reduce the risk that unpaid parties will assert liens against the property. Updated cost-to-complete information permits the lender to determine whether undisbursed commitment funds remain adequate to complete the project.

Advancing the entire commitment at closing would defeat the central draw-control feature of construction lending. The lender should retain control over undisbursed funds until the borrower has satisfied the conditions for each draw. The OCC discusses construction-lending risks, underwriting, inspections, and monitoring in its Commercial Real Estate Lending handbook.

## QUESTION NO: 25

Direct serving loans method requires a system of good internal control and requires that the functions be split between the Accounting Department and the Investment Department. In such a case the Accounting Department is responsible for all of the following EXCEPT:

**A.** Supplying the Investment Department with correct data and reports that summarize all loan transactions

**B.** Alerting the Investment Department promptly whenever an exception to the normal processing routine occurs

**C.** The design, maintenance, and accuracy of accounting records, for periodic management and exception reports, and for statutory statement preparation

**D.** Its records may or may not provide the needed data to support this reporting function

## ANSWER: D

**Explanation:**

“Its records may or may not provide the needed data to support this reporting function” is the correct exception because reliable, complete accounting records are an essential responsibility of the Accounting Department in a properly controlled direct-loan operation. Segregating accounting from investment activity creates an independent recordkeeping and reporting function: accounting must capture loan transactions accurately, maintain the subsidiary and general-ledger support, and produce information that management, investment personnel, and statutory-reporting personnel can rely on. That control objective would not be met if the department’s records only possibly supported required reporting. Instead, the records must be designed and maintained to provide the information necessary for reconciliations, monitoring, exception identification, management reporting, and statutory financial statements. This reliability is particularly important for directly serviced loans because payment activity, principal balances, accrued interest, delinquencies, and other servicing events must be reflected in accounting information independently of the investment decision function. The NAIC’s statutory accounting framework emphasizes the preparation of insurer financial statements using prescribed accounting practices, which depends on supportable underlying records. The COSO internal-control framework likewise identifies reliable reporting as a core objective of internal control. See the NAIC Statutory Accounting Principles and COSO Internal Control guidance.

## QUESTION NO: 26

Which of the following is NOT the interrelated component of internal control?

**A.** Control environment

**B.** Risk assessment

**C.** Control activities

**D.** Planning control

## ANSWER: D

**Explanation:**

Planning control is not one of the interrelated components in the COSO Internal Control—Integrated Framework, the widely recognized framework used to evaluate and design internal-control systems. COSO organizes internal control into five components: the control environment, risk assessment, control activities, information and communication, and monitoring activities. These components operate together across an entity’s objectives, organizational structure, and business processes to provide reasonable assurance that operations, reporting, and compliance objectives can be achieved.

Planning is unquestionably an important management function and may be supported by internal controls, such as budgeting, forecasting, objective setting, and risk-responsive planning. However, “planning control” is not a formally named COSO component. A financial examiner should distinguish between a management activity that can be subject to controls and the framework’s defined internal-control components. This distinction supports consistent examination work, documentation, and assessment of an insurer’s governance and control structure. COSO’s framework overview is available at COSO Internal Control Guidance. The federal Green Book also describes the same five-component internal-control structure at GAO Standards for Internal Control in the Federal Government.

## QUESTION NO: 27

For a life-contingent annuity settlement option, the following provisions may be used to provide protection if the annuitant dies earlier than expected:

**A.** A period-certain guarantee

**B.** A cash-refund feature

**C.** A joint-and-survivor payment arrangement

**D.** A life-only payment arrangement with no guarantee feature

## ANSWER: A B C

**Explanation:**

A period-certain guarantee provides that payments will continue for a stated minimum period even if the annuitant dies during that period. A cash-refund feature generally provides that, if the annuitant dies before receiving payments equal to a specified amount, the unpaid difference is payable under the contract terms. A joint-and-survivor arrangement continues all or a stated portion of income payments to a surviving joint annuitant after the first annuitant dies.

A life-only annuity without a refund or period-certain feature does not provide a payment continuation or refund benefit after the annuitant's death. The availability and precise operation of guarantees depend on the annuity contract. See the NAIC overview of annuities for general information on annuity income options.

## QUESTION NO: 28

Uncollected premiums

**A.** Are also an asset in statutory accounting

**B.** Are usually those past the due date but in the grace period

**C.** Accounting is similar to that for deferred premiums in that only the net premiums are necessary to match the reserve liability

**D.** Only A and B

## ANSWER: A B C

**Explanation:**

Uncollected premiums are premiums that have become due under an insurance contract but have not yet been received. They are recognized as receivables and, subject to statutory admissibility requirements and collectibility considerations, are admitted assets in statutory financial statements. In ordinary policy administration, these balances commonly arise when a premium is past its scheduled due date but the coverage remains in force during the contractual grace period. Therefore, the insurer retains a right to collect the premium while maintaining the related insurance obligation.

The reserve relationship is also important. Like deferred premiums, uncollected premiums affect the timing relationship between premium recognition and policy-reserve measurement. The net-premium component is the amount relevant to matching the reserve liability because policy reserves are fundamentally based on the net valuation premium concept; the portion above that amount represents loading for expenses, contingencies, and profit rather than additional reserve funding. This treatment supports proper matching of the receivable, premium income, and reserve obligation at the reporting date. The NAIC's statutory accounting framework governs recognition, measurement, and admissibility of insurance-company assets and liabilities; see the NAIC Statutory Accounting Principles Working Group and its financial reporting resources.

## QUESTION NO: 29

Which are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance?

**A.** Service acts

**B.** Performance segments

**C.** Control segments

**D.** Operating segments

**ANSWER: D**

**Explanation:**

Operating segments are components of an enterprise that meet the core definition in Accounting Standards Codification Topic 280, Segment Reporting. An operating segment engages in business activities from which it may earn revenues and incur expenses, its operating results are regularly reviewed by the enterprise's chief operating decision maker, and discrete financial information is available for that component. The chief operating decision maker is a function, rather than necessarily a particular job title or individual; this function evaluates performance and makes resource-allocation decisions across the enterprise's components.

This reporting model is intended to provide users of financial statements with information viewed through management's own organizational and decision-making structure. The regular availability and review of separate financial information are therefore essential features of an operating segment. Once operating segments are identified, the entity applies the applicable aggregation and quantitative-threshold guidance to determine which segments must be separately reported in its financial statements. See the FASB's ASC Topic 280, Segment Reporting, and the SEC's Financial Reporting Manual guidance on segment reporting.

**QUESTION NO: 30**

The date on which the contract becomes effective is known as _.

**A.** policy date

**B.** report date

**C.** reinsurance date

**D.** record date

**ANSWER: A**

**Explanation:**

**policy date** is correct because it identifies the date on which the insurance policy takes effect as a contract. From that date forward, the policy's stated coverage period begins, subject to its terms, conditions, and any applicable provisions concerning premium payment, delivery, or conditional coverage. Financial examiners need to identify this date accurately when reviewing whether coverage existed at the time of a reported loss, whether premium was properly earned, and whether liabilities and policy records were recognized in the appropriate period.

The policy date is also a core reference point in policy administration. It supports calculation of policy anniversaries, renewal timing, contestability and suicide periods where applicable, and other contractual durations measured from issuance or effectiveness. Although a policy may be physically delivered, recorded in an administrative system, or reported to a regulator on a different date, those operational events do not alter the contractual date on which the policy became effective. Insurance regulatory materials commonly distinguish policy information and effective dates as essential policy-record data. See the NAIC Market Conduct Record Retention Model Regulation and the IRS Insurance Industry Audit Technique Guide materials for examples of the importance of effective dates and policy documentation in insurance records and examination work.

## QUESTION NO: 31

Which of the following is NOT the date that is the key to classify the chronology of the data?

**A.** policy date

**B.** accident date

**C.** reinsurance date

**D.** report date

## ANSWER: C

**Explanation:**

**reinsurance date** is the correct selection because it is not generally one of the standard primary dates used to organize the chronological development of property/casualty insurance exposure and claim data. Actuarial and financial-examination work commonly analyzes experience according to the date a policy provides coverage, the date a loss occurs, and the date a claim is reported. Those dates establish consistent time-based views of underwriting exposure, loss emergence, and reporting or development patterns. In contrast, reinsurance information is usually associated with a treaty, facultative placement, attachment, cession, recovery, or accounting transaction. The relevant date can therefore vary substantially with the contractual purpose of the analysis and does not serve as a universal chronology classification date for underlying insurance data. This distinction matters when an examiner evaluates reserve analyses, claim triangles, and management reporting: the underlying experience must first be grouped on a clearly defined policy, accident, or report-date basis before reinsurance effects are applied or evaluated. The Actuarial Standards Board's guidance for unpaid claim estimates recognizes the importance of using appropriate claim data and grouping methods in reserve analysis. See ASOP No. 43, Estimating Property/Casualty Insurance Unpaid Claim Estimates and the Casualty Actuarial Society for professional casualty-actuarial resources.

## QUESTION NO: 32

Audit risk consists of:

**A.** Risk of material misstatement

**B.** detection of risk

**C.** Both A & B

**D.** Neither A nor B

## ANSWER: C

**Explanation:**

Both A & B is correct because audit risk is evaluated through two linked components: the risk of material misstatement and detection risk. The risk of material misstatement is the possibility that financial statements contain a material error or omission before the auditor performs audit procedures; it encompasses inherent risk and control risk. Detection risk is the possibility that the auditor's procedures will not detect a material misstatement that exists. Together, these concepts form the audit risk model: Audit Risk = Risk of Material Misstatement × Detection Risk. This relationship is important to a financial examiner because the assessed risk of material misstatement drives the nature, timing, and extent of audit procedures. When the assessed risk of material misstatement is higher, the examiner must reduce acceptable detection risk by obtaining more persuasive audit evidence, such as performing additional procedures or using more reliable sources of evidence. The PCAOB describes audit risk in terms of the risk of material misstatement and the risk that audit procedures fail to detect that misstatement. See PCAOB Auditing Standard 1101 and the AICPA's clarified auditing standards.

## QUESTION NO: 33

Subsequent to the funding of a loan, the most common document/s obtained is/are:

**A.** New or updated appraisals as evidence of the current value of the property

**B.** Current financial statements on the borrower or the property, if the property is income producing, as evidence of the borrower's continuing financial strength and of the property's continuing ability to produce income

**C.** Periodic inspection reports as evidence of the physical condition of the property

**D.** Borrower's financial statements

**ANSWER: A B C**

**Explanation:**

After a loan is funded, prudent loan administration requires ongoing monitoring of both repayment capacity and collateral protection. "New or updated appraisals as evidence of the current value of the property" are appropriate because changes in market conditions, property performance, or physical condition can materially affect collateral value and the institution's loan-to-value exposure. "Current financial statements on the borrower or the property, if the property is income producing, as evidence of the borrower's continuing financial strength and of the property's continuing ability to produce income" are central to monitoring whether cash flow, liquidity, leverage, and operating performance remain sufficient to support debt service. "Periodic inspection reports as evidence of the physical condition of the property" provide evidence that collateral is being maintained, remains in the expected condition, and has not developed physical issues that could impair value or income production. Together, these records support effective ongoing credit-risk assessment, timely identification of deterioration, and appropriate loan-risk ratings. Federal banking guidance similarly emphasizes periodic collateral valuation, financial analysis, and monitoring of real-estate-secured credits. See the FDIC real estate lending standards and the OCC Commercial Real Estate Lending handbook.