Saudi Arabian Monetary Authority

HEAD OFFICE

General Department of Insurance Control

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Dear CEO

SAMA review of Actuarial Reserves as at Year-end 2017

The Saudi Arabian Monetary Authority ("SAMA") would like to thank you for your responsiveness during the course of our review of the year-end actuarial reserves. It was an intensive exercise carried out within a tight timeframe, which could not have been completed without an active cooperation from the Company and your appointed actuary.

Overall, there was noticeable progress made in respect of management's involvement in setting the reserves and in clarity of reporting by the appointed actuaries. There were however several areas which require management and/or the appointed actuary's attention, including the role of the external auditors, increasing loss ratios for Medical Expense insurance, reserve segmentation, etc.

SAMA would like to share the key observations from this *review exercise* with the Company management. It is expected that the Company management will consider each of the items below individually and where actions are necessary, those will be taken promptly.

1. Booked reserves v Actuarial recommendation

In line with SAMA's strategy, this was the most significant change this year as the responsibility for the booked reserves was transferred from the Appointed Actuary to the Company management. Out of **33**, **18** companies booked reserves different from the actuarial recommendation. Of those **18**, **11** companies booked reserves higher than the actuarial recommendation, whereas **7** companies booked reserves lower than the actuarial recommendation, supported by an audit opinion.

SAMA expects the Company management to actively seek to understand the actuarial recommendation on reserves, and the uncertainty around it, and make informed decision on the booked reserves while also complying with the relevant SAMA requirements.

2. Role of the External Auditors

SAMA conducted a survey on the interaction between the external auditors and the appointed actuaries in March 2018. The results of the survey indicated that there is significant room for improvement in the audit of the actuarial reserves. SAMA is coordinating with the audit profession in this regard.

SAMA expects that the Audit Committee at the Company will actively engage with the external auditors in order to ensure that sufficient audit work (including adequate input from the external auditor's actuary) has been performed on the actuarial recommendation on reserves.

3. Reserve Uncertainty

In order to assist the Company management in its decision on the booked reserves, SAMA instructions required each appointed actuary to estimate the uncertainty around the actuarial recommendation on reserves. Based on our discussions with the appointed actuaries, unfortunately, it seemed that there was hardly any discussion between the appointed actuary and the Company management in this regard.

SAMA expects that, in order to make an informed decision on the booked reserves, the Company management will engage with the appointed actuary to understand the level and sources of uncertainty in the reserves recommended by the appointed actuary.

4. SAMA review of the reserves recommended by the Appointed Actuary

The SAMA Actuarial team compiled market benchmarks based on the data received from all insurance companies. Each individual company's results were compared against those benchmarks, and the outliers were discussed with the respective appointed actuaries. In response, the appointed actuaries revised the actuarial recommendations for **21** companies, whereas there were no changes to the original recommendations for the remaining **12** companies. Of those **21** companies, the appointed actuaries reduced the recommended reserves for **8** companies and increased the recommended reserves for **13** companies.

SAMA would like to reiterate that it expects the appointed actuaries to adopt a balanced approach in reserving, i.e., neither an aggressive nor an overly prudent approach shall be adopted, so that the 'true' performance of the business can be determined on a timely basis.

5. Trends in Medical Expense Insurance

We draw the industry's attention to the increasing loss ratio for Medical Expense Insurance. The average gross ultimate loss ratio increased from **64%** in accident year 2016 (2015: **62%**) to **75%** in accident year 2017. In addition to the inflationary trends in the claims cost, we note that significant price competition during the year 2017 for **Corporate** Medical Expense insurance business (as evident from the recent Medical Pricing Adequacy reports) could have also influenced the trend seen in the loss ratio.

SAMA expects that the Company will seek to identify and understand the drivers of the loss ratio trend (e.g., claim cost inflation, pressure on pricing, expenses, etc.) and all necessary measures will be taken to ensure that the terms and conditions of the business written are in line with the risk appetite of the Company. Where there are areas identified for improvement in the processes and policies of the Company, SAMA expects those to be dealt with on a priority basis.

6. Motor experience

Consistent with SAMA's strategy, we have seen evidence of premium rates reducing for Motor insurance, particularly for the Motor Compulsory class, during the recent quarters. This however did not have any adverse impact on the performance of the Motor book; instead, the average loss ratio reduced during accident year 2017. For Motor Compulsory, the average gross ultimate loss ratio reduced from **73%** in accident year 2016 to **70%** in accident year 2017. For Motor Comprehensive, the average gross ultimate loss ratio reduced from **72%** in accident year 2016 to **70%** in accident year 2017.

SAMA expects that the Company will closely monitor the performance of its motor book, including the impact of movements in the premium rates, and of the new pricing and underwriting regime applicable from 24th June 2018.

7. Reinsurance – retention ratios

Other than Motor and Medical, the premium retention ratios remained low generally, the highest for Accident & Liability at **41%** and the lowest for Energy at **2%**. In particular, we note that, despite the Marine class demonstrating low and relatively stable gross ultimate loss ratios consistently over the last four years, the average premium retention is **27%** only. On the other hand, we observed instances of significantly high reinsurance commission for 'other than Motor and Medical' classes. We believe that excessive reliance on reinsurance prevents growth of local experience and expertise in pricing, underwriting, and claims management for those classes as well as exposing the Company to significant counterparty risk. We will monitor this exposure actively under the newly-introduced Risk-based Supervision Framework of SAMA.

SAMA expects the Company to continue to evaluate its reinsurance strategy in light of the emerging experience and its risk appetite, possibly increasing its retention gradually as the Company gains experience and expertise.

8. Comparison between Actual and Expected Claims Development

For 2016 and prior accident years, the '*actual*' claims development during calendar year 2017 was better than the '*expected*' claims development. For all lines of business combined, the *actual over expected* claims development ratio was 93% on a gross of reinsurance basis; this equates to SR 556m savings on the expected claims development. In response to this favorable experience, the appointed actuaries reduced the recommended gross ultimate claims by SR 482m.

SAMA expects that the appointed actuary will continue to monitor the emerging experience, refine assumptions based on that experience, and exercise professional judgment when recommending on the level of reserves to be maintained. In this regard, we expect the appointed actuary to be neither aggressive nor excessively prudent, while ensuring strict adherence to their professional standards.

9. Medical Expense Insurance - role of Third Party Administrators (TPAs)

SAMA would like to express its concern on the general lack of understanding of and supervision by insurance companies of the claims management process where it is outsourced to a TPA. In such cases, we observe that there is limited understanding of the operations of the TPA, its case reserving policy, claims settlement procedures, treatment of pre-approved claims, etc.

SAMA expects that each insurance company will have appropriate protocols in place for receiving adequate and accurate information from TPAs on a timely basis and be fully aware of any claim reporting delays from the TPA. This information must be sufficient for the Company to produce effective and accurate Management Information reports and to meet the needs of the actuarial reserving.

10. Life Insurance - Persistency Ratios

Based on the data submitted by the appointed actuaries, the average customer retention was found to be dismally low. By the end of the fifth policy year, on average, less than **30%** of policies remain in force. This indicates prevalence of mis-selling and consequently customer dissatisfaction in the life insurance market.

SAMA expects that the Company will invest in training of its marketing staff and in improving the value of its product offerings in order to improve the persistency ratios in the market.

11. Actuarial reserves - areas for improvement

11.1. Central estimates v prudence margins

- Instance of explicit prudence margins in reserves were observed by SAMA. This could mask the true performance of the book.
- *We expect that the appointed actuary will aim to determine the 'central' estimate along with the range of uncertainty around it. We expect that the appointed actuary will explain the limitations of the estimates to the Company management, also drawing their attention towards the key assumptions used and judgments made.*

11.2. Quality of submission by the appointed actuaries

- There were instances when, due to errors and omissions, the data required by SAMA had to be submitted multiple times, in some cases up to five times.
- *We expect that the appointed actuary will apply robust checks before submitting any data to SAMA.*

11.3. Range of actuarial methods used

- We observed that, in general, the appointed actuaries use a limited number of reserving methods.
- *We expect that the appointed actuary will consider a wide range of methods, appropriate to the nature and scale of a particular class (e.g., frequency-severity, burning cost methods for motor & medical lines of business, incurred claims based projections, etc.).*

11.4. Reserve segmentation for Medical insurance

- For Medical insurance, we observed a wide variation in the loss ratios across the market. For example, accident year 2017 gross ultimate loss ratio ranged from 46% to 108%. It is suspected that this wide range is driven by the nature of policies written by the insurance companies. Due to a lack of detailed reserving segmentation, it was however not possible to determine the exact cause of this wide range.
- *SAMA expects that the appointed actuary will consider segmenting the medical claims data appropriately (e.g., by benefit category type, etc.),*

enabling a better understanding of the drivers of claims experience and hence to project the ultimate claims more reliably.

11.5. Outstanding claims data for Medical

- Based on our discussions with the appointed actuaries, we understand that outstanding claims data for Medical Expense insurance is either not provided to the actuary or, where it is provided, it is not reliable. Moreover, at various insurance companies, there appears to be no common understanding of outstanding claims data for Medical Expense insurance.
- *SAMA expects that the Company and the appointed actuary will develop a common understanding of the outstanding claims data for Medical Expense insurance, working closely with the TPA (where applicable), and will work to ensure that this data is available for the purpose of the actuarial reserving.*

11.6. Reserve segmentation for Motor

- Generally, the appointed actuaries did not segment the Motor reserves by type of claim (i.e., Own Damage, Third Party Property Damage, and Bodily Injury/Death) or by policyholder type (Corporate v Retail).
- *We expect that the appointed actuary will carry out appropriate investigations in order to decide on the optimal segmentation for the portfolio, including consideration of the differences in the claims development pattern of possible reserving segments.*

11.7. Estimates for Salvage & Subrogation (S&S)

- There were a number of instances where no separate estimates were made for S&S; instead, the projection was carried out on a 'Net of S&S' basis. This runs the risk of not detecting any trends in the recoveries on a timely basis.
- *We expect that, going forward, the appointed actuary will carry out separate projection of S&S recoveries.*

11.8. Treatment of Deductibles and Depreciation

- We noted that, for a number of companies, the S&S data provided for reserving included the amounts for deductibles and depreciation. This distorts the 'true' recovery amounts, since 'deductibles and depreciation' are not true recoveries.
- *We expect that the data used for the S&S projection by the appointed actuary will not include the amounts for deductibles and depreciation.*

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Director General of Insurance Control

<u>Copy to:</u>

- All appointed actuaries