

## Special Comment

# Moody's Global Insurance

April 2008

## Opening of the Brazilian Reinsurance Market – A New Beginning

São Paulo, Brazil

### Summary Opinion

The opening of the Brazilian reinsurance market, effective April 17<sup>th</sup>, 2008, has revolutionized the Brazilian insurance market and, in tandem with the country's sustained economic development, has created new opportunities for insurers and reinsurers globally.

Moody's expects that the opening of the Brazilian reinsurance market will considerably alter the configuration and behavior of the local insurance market, particularly for large commercial and specialty insurers. We believe the opening is overall a positive development that will improve the efficiency of the market through a combination of risk-adjusted pricing and more efficient reinsurance purchasing decisions by ceding insurers. Insurers will likely diversify operations into other lines of business and create new products, supported by the reinsurers' expertise and financial strength. We also anticipate that the insurance market will experience some consolidation over the next few years, as the transition process may be difficult for some insurers, and greater market efficiency will likely marginalize insurers lacking competitive advantages.

Whereas the former reinsurance monopoly and regulator, IRB-Brasil Re, will need major structural and cultural changes to successfully tackle the intense competition from experienced, profit-driven global reinsurers, the company should also be able capitalize on the opportunities provided by the open reinsurance structure, supported by its considerable knowledge of the market.

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## Opening of the Brazilian Reinsurance Market - A New Beginning

### Background

The Brazilian insurance market has been operating under a monopolistic reinsurer since 1939, when the government-sponsored Instituto Brasileiro de Resseguros (IRB) was created to reinsure the local market participants and to regulate the reinsurance market. The process for the market opening began in 1997, when the IRB – already denominated IRB-Brasil Resseguros S.A. – was included in the national privatization program (Programa Nacional de Desestatização, PND). However, the Workers Party (PT), then in opposition, filed a claim with the Supreme Federal Court (STF) invoking unconstitutionality, and the privatization was suspended.

By that time, several foreign reinsurers which had opened offices in Brazil either closed them or significantly reduced their local presence. On January 15<sup>th</sup>, 2007, the federal government (led by the Workers Party) passed the Supplementary Law 126, as another attempt to open the reinsurance market for foreign companies. The delay in regulating the process met with some skepticism from the market, caused by the failed process ten years prior. However, on December 17<sup>th</sup>, 2007, the Private Insurance Superintendent (SUSEP) issued Resolution CNSP 168 and the Brazilian reinsurance market was, at last, formally opened for the international players.

The regulation allows for three types of reinsurers: local, admitted and occasional. The key characteristics for these reinsurers are as follows:

- 1 **Local Reinsurers** – Local reinsurers are companies that operate in the local reinsurance market through a local incorporated and capitalized company. These companies may be independent Brazilian companies or subsidiaries of international firms. Local reinsurers will have the right of first refusal for at least 60% of each reinsurance cession in the general insurance market until January 16, 2010, and for at least 40% during the following three years, ending on January 16, 2013. Local reinsurers will have the right to retain up to 100% of retirement savings and annuities' ceded premiums. These companies will be required to maintain a minimum base capital of BRL 60 million to operate and additional capital in accordance with the current solvency regulation (Resolution CNSP 170).
- 2 **Admitted Reinsurers** – Admitted reinsurers are foreign reinsurers that choose to operate directly in Brazil through a local representative office. These firms must have an insurance financial strength rating that is at least one notch above speculative grade (i.e. Baa3 or higher) and minimum shareholders' equity of USD 100 million or equivalent. Admitted reinsurers must also maintain a foreign currency escrow bank account in Brazil, with minimum balance of USD 5 million, in order to operate in all lines, or at least USD 1 million to operate just in the Life/A&H segment.
- 3 **Occasional Reinsurers** – Occasional reinsurers are foreign reinsurers not having a local representative office (but with a local proxy or power of attorney) that wish to do reinsurance business in Brazil. These companies must be rated at least two notches above speculative grade (i.e. Baa2 or higher), and must have total shareholders' equity of no less than USD 150 million or equivalent. These companies cannot be headquartered in jurisdictions where the income tax rate is less than 20%, effectively excluding reinsurers that are domiciled in tax-advantaged locations (e.g. Bermuda), but not their subsidiaries that operate in higher tax-rate jurisdictions.

A key regulatory constraint, used as a way to prevent substantial capital outflow from Brazil, is that neither insurance companies nor reinsurance companies are allowed to cede more than 50% of total written premiums – except for credit, surety and agriculture/rural insurance. This requirement reduces the possibility of large inter-company cessions/pool arrangements and induces companies to maintain sound underwriting policies and controls at the local level.

There have been several requests from foreign companies to start operations as local and admitted reinsurers. In addition to the IRB-Brasil Re, four companies have filed for licenses to operate through local reinsurers: Munich Re, J. Malucelli (a Brazilian company, specialized in surety business), Mapfre Re and XL Re. There has also been a significant surge in requests for admitted licenses, most notably Lloyd's, Swiss Re, Korean Re, General Re, Transatlantic Re, Transamerica Re, Partner Re and Scor, among several others.

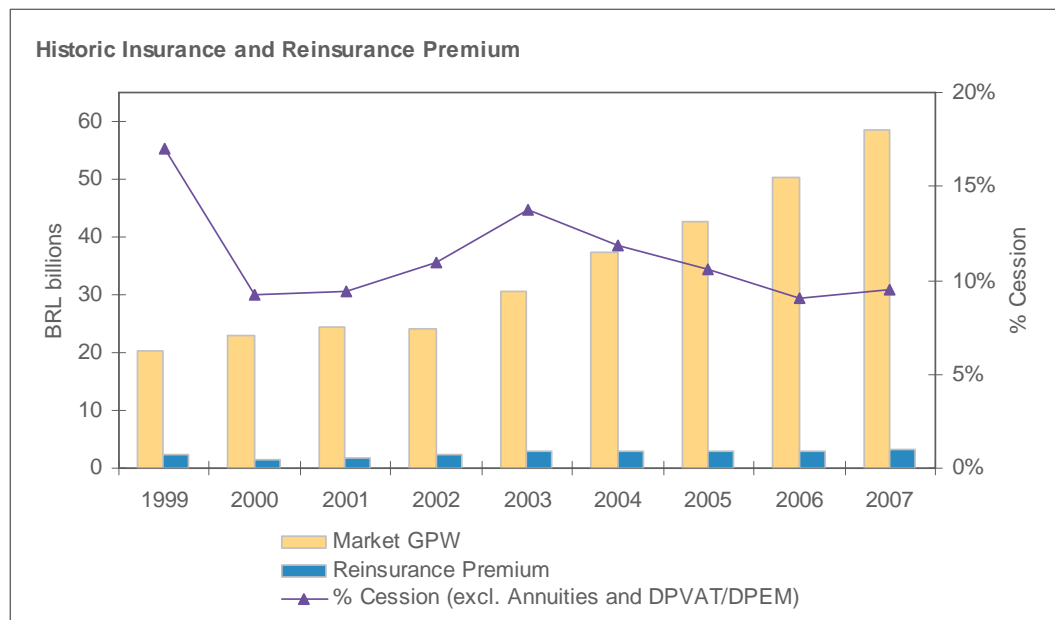
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### An Attractive Market Amidst the Diversification Run of Global Reinsurers

Despite being by far the largest market in Latin America, representing more than 40% of the region's insurance premiums<sup>1</sup>, the Brazilian insurance sector has much room for growth, particularly considering the country's current economic climate and the overall low penetration of insurance in the country's economy. Despite an average annual growth rate of 20% in recent years, the Brazilian insurance market comprises just 2.8% of the country's GDP, which is considerably lower than more developed markets – such as the U.S. (8.8%), Canada (7.0%), UK (16.5%) and Japan (10.5%)<sup>2</sup>.

The sustained development of the Brazilian economy, as well as the country's relatively low exposure to natural catastrophes (e.g. earthquakes and hurricanes) makes the opening of the reinsurance market particularly attractive for foreign reinsurers seeking to expand and diversify their portfolio. We note, however, that catastrophe risk should not be entirely dismissed, as the country has some exposure to floods, landslides, droughts, as well as man-made disasters, such as the 2007 airplane crash at the Congonhas Airport in São Paulo.

Whereas the insurance market has grown considerably over recent years in Brazil, at nearly 20% p.a. since 2003, the reinsurance market has not followed the same trend – as noted in the graph below, which shows the premium ceded as a percentage of gross premiums written. We note, however, that the key driver of recent years' premium growth in Brazil has been the surge in the life and annuities segment, most notably the VGBL product, which though technically a life insurance policy, is marketed and purchased primarily as a tax-deferred savings product and hence results in relatively low reinsurance cessions. Excluding the impact of the annuities segment and the compulsory motor liability (DPVAT/DPEM) lines, the reinsurance premium cession rate has been in the 10% range.

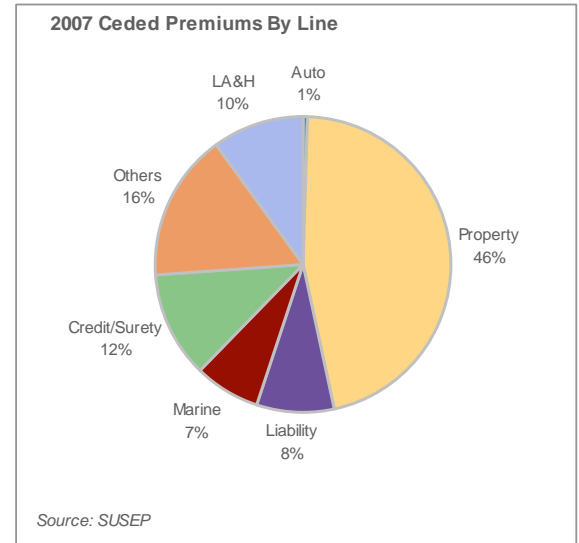
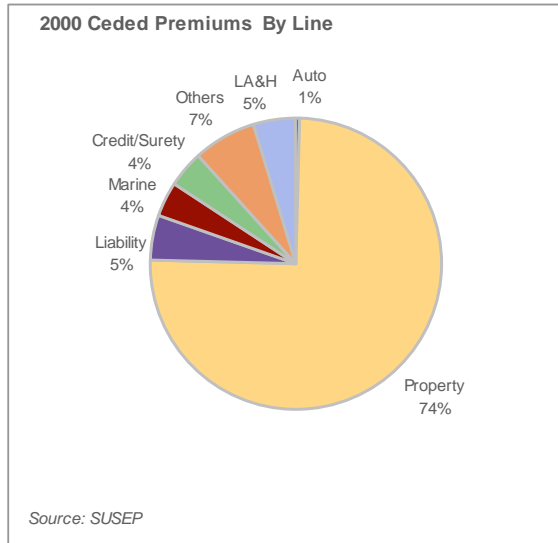


The Brazilian reinsurance market continues to be relatively concentrated in the property segment. However, there has been a significant shift to specialty segments – such as credit, surety and agricultural/rural, among others. We expect these lines of business to sustain high growth rates, especially in light of the continued improvement in the Brazilian economy and new infrastructure projects – driven by the Growth Acceleration Program (PAC). As an example, earlier in 2008, a considerably large surety policy, with sum insured of over USD 1.2 billion, was structured in Brazil to provide coverage for one of the country's major hydroelectric plants as part of the accelerated growth program.

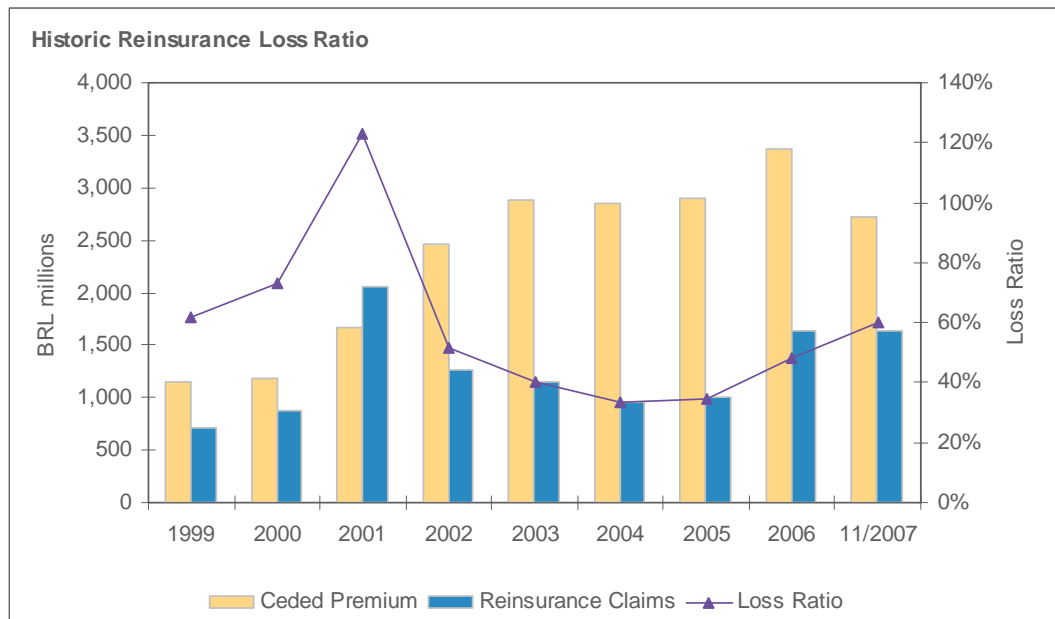
<sup>1</sup> Swiss Re, Sigma No 4/2007

<sup>2</sup> Swiss Re, Sigma No 4/2007

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In addition to the market's considerable growth potential, Brazil is also a profitable alternative for the reinsurers. The local reinsurance market has maintained low levels of losses since 2001, when claims related to the explosion and consequent sinking of Petrobras' floating oil platform P-36 resulted in large reinsurance losses – BRL 1.3 billion or, approximately, USD 500 million at the time of the event.



## Opening of the Brazilian Reinsurance Market - A New Beginning

### Implications on Market Structure and Behavior

Moody's believes that the opening of Brazil's reinsurance market is overall a positive development that will improve the efficiency of the sector through a combination of risk-adjusted pricing and more efficient reinsurance purchasing decisions by ceding insurers, as well as through consolidation among Brazil's many licensed insurers.

Moody's expects that the opening of the Brazilian reinsurance market will considerably alter the configuration and behavior of the local insurance market, particularly for large commercial and specialty insurers. The traditional use of tariff-based pricing applied by IRB-Brasil Re will be replaced by experience-adjusted underwriting. We also expect the current preponderance of proportional treaties to be reduced, as more underwriting-focused insurers seek to utilize their reinsurance purchases more efficiently and to retain a higher level of underwriting profits, and as reinsurers seek to limit their exposures.

While history has shown that prices tend to decline soon after a market opens, the Brazilian market may not necessarily encounter a similar outcome. The small- and medium-sized insurers, as well as those lacking underwriting and claims handling expertise – traditionally aided by IRB – will likely find that their cost of reinsurance will rise to a certain extent and, as a result, their ability to compete with larger, more proficient players will be hampered. On the other hand, insurers with controlled underwriting policies and solid financial fundamentals and credit profile are expected to see their reinsurance rates reduced and will be able to focus on other strategic initiatives, partnering with reinsurers to develop new products and to seek new opportunities – providing coverage for more complex risks.

Moody's expects the market to face some consolidation over the next few years; insurers will diversify operations into other lines of business and create new products, supported by the reinsurers' expertise and financial strength. Also contributing to future growth of the market are the country's economic development – with a growing infrastructure program, backed by the federal government – and the cross-border expansion of Brazilian companies, which are increasingly acquiring companies abroad – supported by a stronger currency – , which may also increase the utilization alternative risk transfer arrangements, such as captives.

The opening of the reinsurance market will also lead to changes in the majority of the local insurance companies' operational and technological processes. The exchange of information from insurance companies to reinsurers has to be transparent and fast-paced, and reinsurance companies prefer to do business with insurance companies that provide high-quality data and maintain a clear and constant channel of communication. This exchange is crucial for the reinsurers to better assess the underlying risk and price it accordingly. More common than not, reinsurance companies require copies of the insurers' underwriting guidelines, as a way to control and ensure rates are calculated accordingly.

Ultimately, the end-consumers will also benefit, as the insurance companies will be able to better meet their needs, with more flexible, tailor-made coverages. The monopolistic environment, with little pricing differentiation, hindered the development of new products and coverages in the local market. The traditional inefficient treaty structures will make room for more flexible clauses, which, consequently, will be reflected in the insurance policies. We note, however, that the credit risk of the insurance companies – supported by their reinsurance coverage arrangements – will increasingly become an essential consideration in the decision making process of the prospective policyholders.

Another major impact will be related to human capital. Decades of a monopolistic market structure brought about a sector-wide lack of technical reinsurance expertise in the local work-force. As a general rule – though we note with some exceptions – insurance companies were not necessarily compelled to invest in the development of their personnel in the tight marketplace scheme. By most accounts, foreign reinsurers entering the market (and IRB itself) have found difficulty in hiring highly-qualified professionals. Moody's notes that this weakness will result in higher up-front costs for the market in general, as companies will have to seek expertise abroad and/or provide the necessary training at a faster rate.

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### A New Era for IRB-Brasil Re: Privatization Is Unlikely

Before the creation of IRB, reinsurance was either done directly abroad or through the foreign companies established in Brazil. In 1939, the Brazilian federal government decided to create a monopolistic reinsurer, namely IRB, as a way to increase the capacity of insurance companies at the local level and to retain more business volume, and the associated profits, in the country.

The current change in the market structure has a significant difference from the prior proposal. In the first attempt to open the reinsurance market in Brazil, IRB was a target of privatization. However, this time around, it is likely that the company – which is majority-owned by the federal government – will remain a state-owned enterprise, at least for the foreseeable future, and will compete with the local reinsurers.

The once monopolistic reinsurer and regulator is going through significant structural and cultural changes to better compete in this new era. The company has announced that it is reassessing its governance, management structure and investment portfolio, in addition to training and developing its work-force.

In Moody's view, IRB-Brasil Re should be able to capitalize on the opportunities provided, and it will have a relative near-term advantage over its competitors, given its thorough knowledge of the local market. That said, the bureaucratic processes associated with state-owned companies in Brazil will significantly mitigate its effectiveness in competing in an increasingly dynamic market. We also note that IRB's historical role of supporting underperforming insurers will also likely cease, as it will need to avoid the possibility of adverse selection arising from a more competitive market now available to better-performing insurers.

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### Moody's Related Research

#### Industry Outlook:

- Global Reinsurance Industry Outlook, September 2007 (104363)
- Moody's Outlook for the Brazilian Insurance Market, October 2006 (100289)

#### Insurance Statistical Supplement:

- Brazil Insurance Industry, April 2008 (107908)

#### Rating Methodology:

- Moody's Global Rating Methodology for Reinsurers, September 2007 (104453)
- Profiles Explanatory Notes & Lloyd's Syndicate Ratings Methodology, July 2007
- Moody's Global Rating Methodology for Property and Casualty Insurers, September 2006 (98046)
- Moody's Global Rating Methodology for Life Insurers, September 2006 (98207)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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Report Number: 108874

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