

Industry Outlook

Moody's Insurance

February 2009

Brazilian Insurance Industry Outlook

Summary Opinion

Stable outlook – Our credit outlook for the Brazilian insurance industry is stable, reflecting our expectations that fundamental credit conditions for the market will be sustained over the next 12 to 18 months, albeit challenges from global economic instability, including possible global stagnation and de-leveraging. Although profitability may be pressured, as investment income declines, underwriting profits should be sustained by the Brazilian insurance companies. Additionally, we expect overall capitalization levels to improve, mostly from shareholder contributions, as new solvency margin regulation comes into play, raising capital requirements. The Brazilian insurance industry's stable outlook also contemplates Moody's view that whereas the local market will grow at a slower pace than recent years, it will continue to grow, nonetheless.

Significant market developments should contribute to sector growth –

Consistent growth in most insurance segments over recent years was supported by the developing Brazilian economy, the increased consumption spending and industrial production, as well as the broader availability of credit (e.g. auto financing and mortgage). In addition to these factors, the significant structural changes in the Brazilian insurance sector – namely, the opening of the reinsurance market and the new minimum capital requirements – will also be major contributors to the sustained development of the market.

Largest market in Latin America, but with much room for growth –

The Brazilian market is the largest in Latin America, accounting for 44% of the region's total premium¹. That said, its penetration relative to the country's GDP (about 3%) is low, particularly when compared with more developed markets. Recent market developments, as well as the potential expansion of certain market niches could help the Brazilian insurance segment grow at higher rates than other developing markets in the near and medium term.

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¹ Swiss Re, Sigma No 3/2008



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Consolidation trend should continue – Over recent years, the Brazilian insurance market has experienced some consolidation, as well as increased participation by international insurance organizations through a combination of acquisitions and joint ventures with established domestic insurance groups. Moody's expects that this trend will likely carry on, mainly as a result of recent structural and regulatory changes (i.e. reinsurance market opening, new solvency margin requirements, and recent healthcare legislation instructing healthcare companies to cover several new procedures), leading to further rationalization in market structure. Additionally, Moody's notes that the following reasons could also accelerate the market concentration process: 1) Recently-approved measure (MP 443) allowing state-owned Banco do Brasil and Caixa Econômica and their insurance subsidiaries to control insurance, pension and *capitalização* companies; 2) Devaluation of the Brazilian currency (Real), which increases the local companies' attractiveness to foreign investors; and 3) Recent merger between Itaú and Unibanco groups – further concentrating the market and, therefore, weakening the smaller firms.

Greater focus on underwriting results will help as earnings are pressured – Historically, underwriting results of most Brazilian insurers were poor, and earnings were largely supported by investment income. However, the trend has shifted to stronger underwriting profits and reduced investment yields in recent years – insurance companies' investment portfolio yield returns have declined to 17% of net premiums earned in 2007, from a high of 25% in 2003. The greater importance given to underwriting results should assist the Brazilian insurance companies to better handle the expected earnings pressures set by the economic slow-down and the likely end of the increasing interest rate cycle.

New minimum capital requirement should enhance capitalization – The market's rising operational leverage peaked to its highest level of the past 10 years in 2007 – at 6x total shareholders' equity –, and equity as a percentage of assets reached a low of 17% in 2007, compared to 23% in 2003. The new solvency margin regulation, however, should lead to improved capitalization of the companies, as they will be required to enhance their capital levels substantially. Moody's notes, however, that some companies – particularly the small and medium-sized independent insurers – may find difficulty in raising additional capitals because of the fallen liquidity and the tighter credit availability in the local and global markets.

Reinsurance market opening creates new opportunity for local and foreign players – The opening of the Brazilian reinsurance market will revolutionize and will lead to major changes in the industry. Local insurance companies will improve efficiency through a combination of risk-adjusted pricing and more effective reinsurance purchasing decisions. Insurers will also likely diversify their operations into other lines of business and create new products. The reinsurance market opening is an important occurrence for foreign insurance and reinsurance companies wishing to expand their operations worldwide.

Key Strengths & Opportunities for the Brazilian Insurance Market

- **Moderate exposure to global economic turmoil** – Notwithstanding the current general de-leveraging and decline in commodity prices – which should negatively impact growth of the Brazilian economy, and, consequently, lead to a more moderate growth rate of the local insurance sector – Moody's considers the local insurance companies to be well-positioned to face these challenges, supported by the expected improvement in their capital position and sustained solid profitability. Additionally, Brazil's exposure to the external financial turmoil has been alleviated somewhat by the country's improved macro-economy and strong domestic demand, which should also help mitigate the impact of the challenging global economic environment in the Brazilian insurance market.
- **Established distribution systems and growing alternative channels** – Bancassurance is the main channel for life and pension products, while independent and multinational brokers are the major distributors of general insurance products; sales through sponsors (affinity marketing) is increasingly becoming an important distribution channel in the market, particularly for non-bank-affiliated insurers.

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- **Improved underwriting results** – Whereas earnings have recently declined, stronger underwriting results and reduced dependence on investment income are major market improvements, particularly in comparison with other major markets in the region.
- **Market growth potential** – Although the market has been consistently growing at high rates – 16% (13% excluding VGBL) over the last three years– the Brazilian insurance sector's penetration in the overall economy remains low vis-à-vis more developed markets. As a result of the global economic slowdown, the market should develop at a lower rate than observed in prior years, but we expect it should continue to outpace the country's economic growth rate in the near and medium term.
- **Supportive insurance regulatory regime** – Moody's views the recent market developments positively. SUSEP has implemented important rules that should contribute to enhance financial transparency, as well as more sophisticated underwriting and actuarial approaches. Additionally, prudent regulatory mandates have strengthened the system and mitigated the impact of current economic vulnerability in the local market.
- **Modest exposure to natural catastrophes** – Brazil has a relatively benign natural catastrophe environment relative to other major markets in the region, with little exposure to large catastrophic losses deriving from hurricanes and earthquakes. We note, however, that there is some exposure to catastrophe in Brazil, and, therefore, this risk should not be entirely dismissed.

Key Concerns & Risks for the Brazilian Insurance Market

- **Intense price competition and relatively high customer turnover** – Local competition remains highly price-oriented, with competition still mostly targeting other companies' clients, rather than seeking untapped market niches.
- **Restrictive investment possibilities restrain asset quality and heighten risk concentration** – The local restrictive investment regulations result in both credit and concentration risk for the local insurers and impair their credit profiles. The vast majority of the Brazilian insurance companies' investments are allocated to Brazilian government bonds, which are rated Ba1 and considered to have substantial risk. Insurers' profitability is dependent on investment performance, and the limitations on asset allocation possibilities constrain the insurers' investment returns.
- **Increasing operational leverage** – Along with diminished earnings and high premium growth rates, overall capitalization has been declining, as measured by the rising gross underwriting leverage. Insurers will likely need to raise additional capital to sustain solid growth rates and to comply with new solvency regulations. That said, greater array of risk-transfer possibilities – as a result of the opening of the reinsurance market – may alleviate the need for companies to raise new capital. We note, however, that reliance on reinsurance for capital relief is not always feasible or available.

Industry Overview

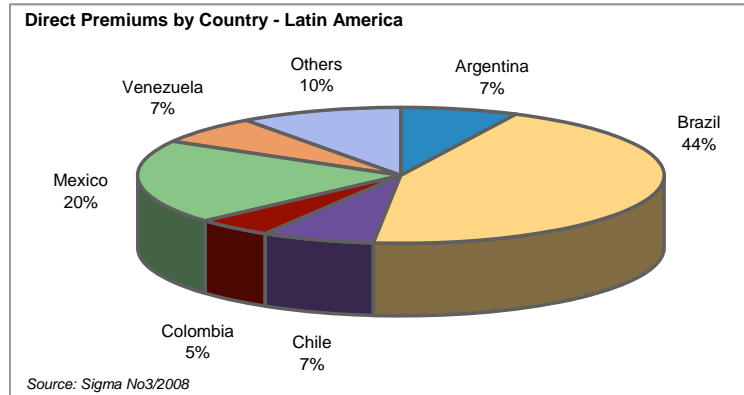
Largest Market in Latin America

Brazil is geographically large and holds the world's fifth-largest population at an estimated 186 million. Moody's believes the country's size offers the potential of becoming a more prominent insurance market over the medium-to-long term across all segments.

The Brazilian insurance market is by far the largest in Latin America. With approximately 44% premium market share, it is more than double the second-largest market in the region, Mexico's, which accounts for nearly 20%² of total insurance premiums. Brazil's penetration of Latin America's premiums would be amplified – bringing it closer to 50% of the region – by including the healthcare and workers' compensation segments. These are not regulated by the insurance regulatory body (SUSEP – division of Ministry of Finance), but rather by ANS, a division of the Ministry of Health, in the case of healthcare, and by the social security system, in the case of workers' compensation.

² Swiss Re, Sigma No 3/2008

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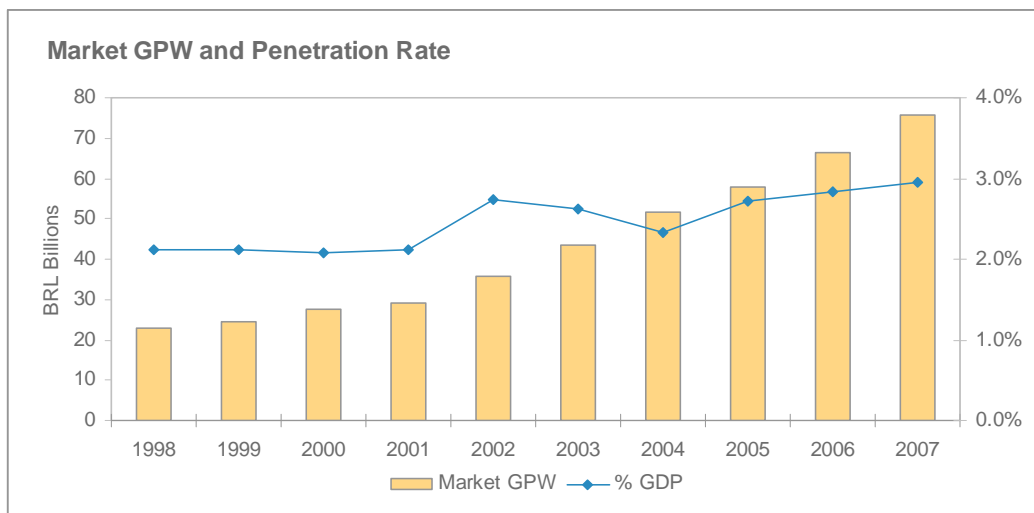


Insurance Penetration Remains Low, but has Improved

The Brazilian insurance market (encompassing general insurance, life & annuities and healthcare), as well as the *capitalização* market, has been sustaining significant growth over recent years, but its penetration rate, relative to the country's GDP, remains low, in the 2% to 3% range. Although comparable with other markets in the region, this range is well below more developed markets – e.g., US 9%, France 11%, and Japan 10.5%.

The Brazilian insurance sector's somewhat modest importance to the economy reflects the influence of several factors: 1) the high degree of wealth disparity and concentration among the population; 2) the relatively recent design of tax incentives for retirement savings products relative to more seasoned plans in other countries; 3) the low utilization of commercial and personal property and liability insurance; and 4) doubts among the population regarding the value of insurance.

We expect the market to grow at a much lower rate than observed in recent years, largely because of reduced economic growth. However, it should outpace the country's economy, largely supported by the recent market developments.



Key Accounting and Regulatory Considerations

Regulatory Changes Are Driving Market Development

Two important recent developments of the market – revised minimum capital requirements and opening of the reinsurance market, led by SUSEP – were major steps forward for the progress of the insurance market – mainly for the general insurance segment, at present. In addition to the mandates mentioned above – and including establishment of accounting procedures, financial reporting and actuarial standards – SUSEP has also been active in setting guidelines for internal controls and monitoring insurers' investments.

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Some regulatory constraints have mitigated the development of healthcare insurance in Brazil. Healthcare insurance – a highly politicized segment in Brazil, as in many other countries – underwent significant turmoil in recent years, as medical inflation costs, together with increased costs related to heightened utilization and medical technology advances, substantially outpaced permissible premium rate increases by the regulator. The individual healthcare business written by the private insurers is almost entirely in runoff because of inadequate state-mandated premium rates.

Opening of the Reinsurance Market and Implications

The reinsurance market in Brazil has been effectively open for competition since April 2008. That said, Moody's views the reinsurance market as being in a transition phase – no longer a monopoly, but not fully an open structure. This arises from certain regulatory restrictions– such as limitations on premium ceded to foreign (occasional) reinsurers and the right of refusal of local reinsurers (at least 60% until 2010 and at least 40% thereafter) for all ceded businesses. Moody's notes, however, that this transition market structure does not constrain medium-term market growth prospects and allows local players time to get fully accommodated to competing in an open market environment.

Moody's expects that the opening of the Brazilian reinsurance market will modify the configuration and behavior of the local insurance market, particularly for large commercial and specialty insurers. 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.

Moody's expects that the local insurers with controlled underwriting policies, solid financial fundamentals and credit profiles should see their reinsurance rates reduced, enabling them to tackle other strategic initiatives, partnering with reinsurers to develop new products and to seek new opportunities – e.g. more complex risk coverage.

The opening of the reinsurance market will also lead to changes in many of the local insurance companies' operational and technological processes. The need for efficient and transparent channel of communication between insurance companies and reinsurers is crucial, and reinsurance companies prefer to do business with insurance companies that provide high-quality, credible data, as it significantly enhances the reinsurers' ability to assess the underlying risk and price it accordingly.

Moody's also sees the end-consumers benefiting from this change in market structure, 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, restrained the development of new products and coverages in the local market. The traditional inefficient reinsurance treaty structures will make room for more flexible clauses, which, consequently, will be reflected in the insurance policies. 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.

Continued Focus on Financial Transparency and Greater Consistency in Accounting Standards

Financial transparency continues to be an important focus of the insurance regulators and the government. On December 28, 2007, the Brazilian government passed a new law (Lei 11638), modifying and instituting new provisions to the previous law (Lei 6404/76). Among several changes, we highlight two in particular:

- All publicly-traded companies and those privately-owned with either total assets above BRL 240 million or gross revenue above BRL 300 million will have to abide by these new rules and issue financial reports audited by independent firms.
- The companies which meet the above criteria will now be required to issue a Cash Flow Statement – with the exception of privately-owned companies with shareholders' equity below BRL 2 million – and a Value Added Statement, only for publicly-traded companies.

In addition to this law, as Brazil is seeking convergence to International Financial Reporting Standards (IFRS) by the end of 2010, SUSEP has announced, via Circular 357/07, that it will identify the needs for convergence

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to the current system to IASB's (International Accounting Standard Board) standards. Moody's considers these new changes an overall positive development for the Brazilian insurance market. That said, the changeover to IFRS will present both opportunities and challenges to the sector. Among the opportunities, we note:

- Enhanced transparency and disclosure, with more detailed information from companies concerning the nature of their risks;
- Smoother cross-border comparison with international peers – including US companies, as the IASB and the US Financial Accounting Standard Board (FASB) are working towards convergence between IFRS and US GAAP.

Among the challenges of the convergence to the new rules, Moody's identifies the following:

- The local insurance market is managed by strict regulatory oversight, with several rules and guidelines set by the local regulators, whereas IFRS is founded on principles and judgments;
- Uneven level of readiness among local insurance companies;
- Companies' reported results will likely become more volatile, as a result of the fair value accounting; and
- Effectiveness of historical data will be limited, particularly when doing multi-year comparisons – companies will be required to disclose comparable financials for the prior period only.

Meanwhile, SUSEP has established a number of credit and market valuation reserves that insurers must carry on their balance sheets for assets, along with financial and claim variability reserves for their liabilities, in an effort to ensure an appropriately conservative reporting of financial results and insurer capitalization.

Global Economy Considerations Underlying Current Outlook

Moody's Global Financial Risk Unit has published a series of reports – the most current publication is "Global Macro-Risk Scenarios 2009-2010 – From Global Integration to Global Dis-integration?" – describing several scenarios for the global economy for 2009 and 2010. Moody's believes that in addition to a downturn in developed economies, emerging markets will face economic deceleration, amid capital repatriation and deleveraging, potentially leading to a global stagnation.

The Brazilian insurance industry's stable outlook incorporates Moody's view that, notwithstanding the downside risks related to the global economic situation, the industry will maintain its fundamental credit conditions, over the next 12 to 18 months. The restrictive investment directives for local insurance companies limited, to some extent, their exposure to more volatile assets. Additionally, Brazil has become better equipped to sustain adverse external shocks, which also limited the insurance industry's exposure to the current global economic environment.

The downside risks for the local insurance companies include the reduction in customers' spending, which could reduce demand for insurance products – both personal (automobile, life, homeowners etc.) and commercial insurance. Growth of the annuities and pensions segment may also decline, as the amount of financial resources available for long-term savings and retirement will likely reduce. Further challenges include the significant increase in funding costs and consequent limited financial flexibility, especially for medium and small independent companies seeking to boost capital levels to comply with the new minimum capital regulatory demands.

Notwithstanding the concerns mentioned above, we believe that the Brazilian insurance industry is well-positioned to face the challenging global economic environment, sustaining its fundamental credit strengths.

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Business Profile

Distinct Structure for Each Segment of the Market

Brazil's insurance market comprises four distinct segments: general insurance, life and pensions, healthcare and *capitalização* – a unique product which combines lottery-based drawings and personal savings features. The market has 139 active insurance companies, from some 80 individual economic groups. Of these companies, 83 are general insurers, 32 are life and pension companies, 13 are *capitalização* companies and 11 are healthcare insurance companies. Notwithstanding the sizeable presence of international insurance companies, both through wholly-owned subsidiaries (e.g. Allianz, Mapfre, MetLife, Liberty, Chubb and ACE, among others) and joint ventures – e.g. ING with SulAmérica, Principal with Banco do Brasil (Brasilprev), CNP Assurance with CAIXA and, more recently, AEGON with Mongeral – the national players remain among the most prominent companies in the local market – e.g. Bradesco, Itaú-Unibanco and Porto Seguro.

General Insurance

Although still relatively concentrated, the general insurance segment is the most fragmented sector of the Brazilian insurance market – the ten largest insurers account for approximately 65% of total gross premium. We expect that this segment will likely face further concentration, as local companies steadily pursue greater market share, and smaller, less efficient insurers encounter greater difficulty adjusting to the new market structure and competing in a more challenging economic environment.

General insurance products are distributed primarily through independent brokers, although the use of alternative channels is expanding. Commercial, specialty lines and international-based risks are largely sold through international brokers (most notably Marsh & McLennan, AON and Willis), whereas independent brokers are a firmly established network serving the personal automobile and small/mid-market commercial customer segments in Brazil and are highly unionized and politically influential. The exceptionally high number of brokers in the country, together with laws that effectively mandate the use of intermediaries, also constitutes a strong collective political influence against direct marketing initiatives.

Top 15 General Insurers – Premiums (Last 12 mos)

Company	Group Share	Cumul. Share
Porto Seguro Cia de Seguros Gerais	10.6%	10.6%
Bradesco Seguros (Bradesco Auto/Re & Atlântica)	10.1%	20.7%
Unibanco Seguros	9.5%	30.2%
MAPFRE Vera Cruz Seguradora	6.8%	37.0%
SulAmérica Seguros	6.6%	43.6%
Itaú Seguros (A2/Aaa.br)	5.2%	48.8%
Allianz Seguros	5.0%	53.8%
Tokio Marine Seguradora	4.3%	58.1%
HDI Seguros	3.5%	61.6%
Brasilveículos Seguros (Grupo SulAmérica)	3.5%	65.1%
CAIXA Seguros	3.2%	68.3%
Liberty Seguros	2.9%	71.2%
Marítima Seguros	2.5%	73.7%
Aliança do Brasil	2.3%	76.0%
Itaú XL Seguros	2.1%	78.1%

The general insurance market has been traditionally focused on property and automobile insurance. However, there has been a shift into more specialized lines of business, such as credit, surety, and agricultural. The rising importance of these specialty lines, coupled with the expectations that these niches will continue to grow

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above the market average, has contributed to the increased interest of local companies and the establishment of new market entrants, such as Coface, Euler Hermes, MAPFRE's credit and surety company, Credito y Caución and others.

Moody's expects that the opening of the reinsurance market in Brazil will generate greater impact in the general insurance segment, mainly for large risks – commercial, industrial and some specialty lines. These insurers will likely be forced to strengthen their underwriting and risk management capabilities, as well as obtain stronger knowledge of how to operate in an open, competitive market environment. Moody's notes that the larger general insurers, supported by their size and capital backing, as well as multinational insurers seeking stronger local market position will likely prompt greater merger and acquisition activity to gain economies of scale and, as a result, be able to better compete in the new market structure.

Life Insurance and Retirement Savings

The Brazilian life and retirement savings segment has been experiencing strong growth over recent years, reflecting the improving economy and the changing attitudes toward life insurance and retirement savings products resulting from the tax benefits they provide. Although life insurance in Brazil emphasizes term life insurance, with primary risk of mortality and little surrender risk, the pensions and annuities products (particularly VGBL and PGBL) are the designated asset accumulation vehicles. More complex life insurance policies, such as universal and variable life, are not common, and, therefore, there is a clear dividing line between mortality protection and retirement savings products.

The main driver for the extraordinary growth of the life insurance and retirement savings market – which accounts for 41% of the total insurance market in Brazil, compared with 23% five years earlier – is related to the tax benefits of the two leading products of this segment: PGBL (Plano Gerador de Benefício Livre) and VGBL (Vida Gerador de Benefício Livre).

- **PGBL** – The PGBL product was created in 1998, but became a better accepted product by the consumers in the early part of this decade. Contributions to the PGBL are tax-deductible (up to 12% of the investors' gross income), but surrenders are taxable according to the chosen tax regime (either progressive or regressive).
- **VGBL** – The VGBL product, launched in 2002, is a more attractive alternative for the population in the lower income-brackets – mostly those not required to file income tax returns. The main differences distinguishing it from PGBL are that contributions are not tax-deductible and, at the time of surrender, tax is levied solely on the investment returns, not on the whole amount.

The power of the bancassurance platform as a distribution channel in this segment has been shown by the considerable dominance of bank-affiliated insurers, which control approximately 85% of total industry-wide premiums and deposits.

Top 15 Life Insurance and Retirement Savings Companies – Premiums and Deposits (Last 12 mos)

<i>Company</i>	<i>Group Share</i>	<i>Cumul. Share</i>
Bradesco Vida e Previdência	29.9%	29.9%
Itaú Vida e Previdência (A2/Aaa.br)	16.1%	46.0%
Brasilprev	8.2%	54.2%
CAIXA Seguros	6.8%	61.0%
Unibanco Seguros e Previdência	6.4%	67.4%
Santander Seguros	5.2%	72.6%
HSBC Vida e Previdência	4.6%	77.2%
Real Tokio Marine Vida e Previdência	3.4%	80.5%
Aliança do Brasil	2.6%	83.1%

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Top 15 Life Insurance and Retirement Savings Companies – Premiums and Deposits (Last 12 mos)

Company	Group Share	Cumul. Share
MAPFRE Vera Cruz Vida e Previdência	2.2%	85.3%
Icatu Hartford Seguros	1.8%	87.1%
Metropolitan Life Seguros e Previdência	1.7%	88.8%
SulAmérica Vida e Previdência	1.4%	90.3%
MAPFRE Nossa Caixa Vida e Previdência	1.1%	91.3%
Porto Seguro Vida e Previdência	1.0%	92.4%

Brazil continues to experience improving mortality trends. Although these are favorable for life insurance products, insurers will need to carefully consider their assumptions for annuities at retirement, as well as the mortality tables and interest rates guarantees, which are determined at the initiation of the pension plans. The pensions market is currently overall in accumulation mode, but Moody's expects that the market will likely shift to a payout mode in about 15 years.

The recent major structural market changes in the Brazilian market – i.e. reinsurance market opening and new minimum capital requirements – should have relatively little impact on the way this segment operates. Whereas we believe players in this sector may be encountering an equally strenuous competitive environment as its general insurance peers, consolidation among life insurers is unlikely, absent mergers among banks themselves. We expect to see further concentration of business with the top players in this segment, as a result of major companies' mergers – namely Santander and Real, as well as Itaú and Unibanco – which will likely strengthen these companies' positions.

Capitalização

The *capitalização* product is unique to Brazil and was created to promote savings mostly among the lower/middle classes – also referred to as C and D classes. There are currently 13 active *capitalização* companies, most of which are bank-affiliated. These products are typically linked to life insurance or are used to generate sales of other insurance products. Relative to other segments of the Brazilian insurance market, *capitalização* deposits have stagnated somewhat in recent years. That said, because of its attractiveness to the less affluent classes of the population, the *capitalization* segment has a broader geographic diversification than the other market segments, which have a greater concentration of business in the southern states of the country.

Capitalização Companies – Net Deposits (Last 12 mos)

Company	Group Share	Cumul. Share
Brasilcap (Banco do Brasil)	23.4%	23.4%
Bradesco Capitalização	18.9%	42.4%
Cia Itaú de Capitalização	10.6%	53.0%
CAIXA Capitalização	9.1%	62.1%
Icatu Hartford Capitalização	8.3%	70.4%
Unibanco Capitalização	7.1%	77.5%
Real Capitalização	6.2%	83.7%
Santander Capitalização	4.8%	88.5%
HSBC Capitalização	3.9%	92.4%
SulAmérica Capitalização - SulaCap	3.7%	96.2%
Liderança Capitalização	3.1%	99.3%
APLUB Capitalização	0.7%	100.0%

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Capitalização Companies – Net Deposits (Last 12 mos)

Company	Group Share	Cumul. Share
MAPFRE Capitalização	0.0%	100.0%

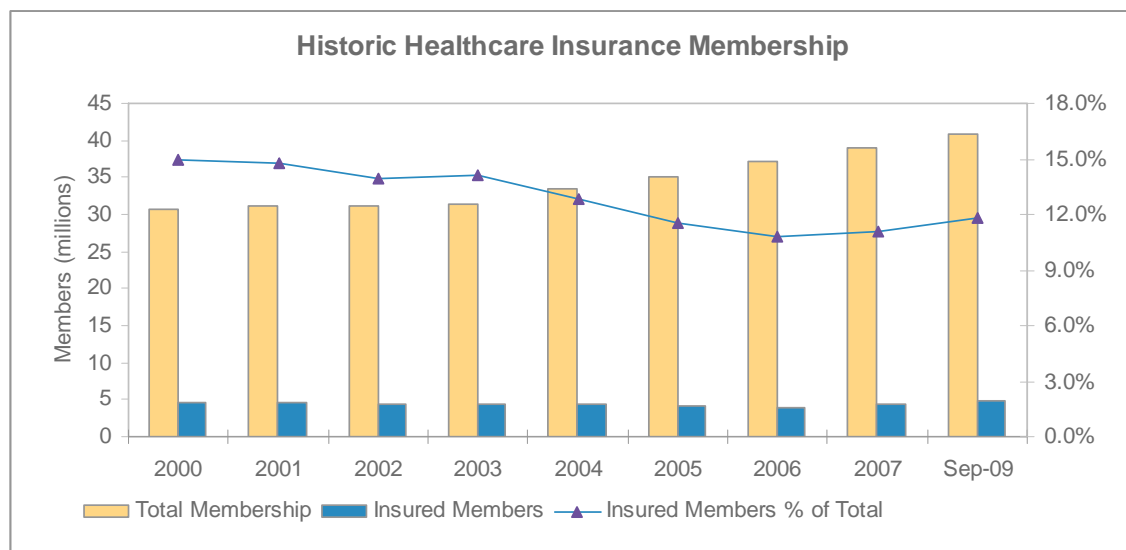
The *capitalização* product features an accumulation period of three to five years, and a percentage of the asset balance is allocated to purchase participations in the national lottery, with the individual's lottery numbers being selected at the initiation of the contract. Two kinds of lottery participations are offered: monthly (smaller values) or single-premium (larger values), and the individual keeps any lottery gains, in addition to earned interest on the remaining of the account balance. This is a high-margin business for the companies, and the key focus is on expanding product distribution.

Although there appears to be extremely little or no risk of loss or default for *capitalização* companies, Moody's points out that the capital structure of some companies appears to be weak, and regulators have expressed some concern about the management of certain companies' funds. Operational control and evolving capital requirements are therefore likely to be forthcoming.

Healthcare

The healthcare insurance market is regulated by a different government body than the other three market segments, the National Health Agency (ANS), which is under the Health Ministry. This segment has gone through significant changes since the implementation of the 9.656/98 law, which required companies to provide coverage for several procedures – later augmented by the resolution RN167, of April 2008 – and consequently limited the flexibility of insurers to manage their plans and pricing, particularly their individual/family policies.

The result has been a considerable decline in the number of companies providing medical coverage (currently only 11 companies), as well as in the number of covered members relative to the overall private medical membership. By and large, the individual/family insurance plans are in run-off. Although many insurance companies with large exposures to the individual policies have established premium deficiency reserves, we believe that further reserve revisions will be essential because the current reserve levels may be significantly below required levels.



The healthcare insurance sector is highly concentrated. The two largest companies, Bradesco Saúde and SulAmérica Saúde together account for approximately 80% of total insured members – not including members covered under ASO (Administrative Services Only) plans. The increase in mandatory covered procedures may constrain the healthcare insurers' earnings because they will face timing and lag risks, as a consequence

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of not being able to immediately raise premium rates to the desired levels. That said, the increased focus on group accounts offers some flexibility to healthcare insurers to adjust rates accordingly; fortunately for them, rate adjustments in this niche of the market are not dependent on the regulator's approval.

Healthcare Insurers – Premiums (June 2008)

Company	Group Share	Cumul. Share
Bradesco Saúde	41.1%	41.1%
SulAmérica Saúde	36.2%	77.3%
Porto Seguro Saúde	6.2%	83.5%
Allianz Saúde	3.3%	86.8%
Marítima Saúde	3.1%	89.9%
Unibanco Saúde	2.9%	92.8%
Unimed Seguros Saúde	2.9%	95.7%
Notre Dame Seguradora	2.1%	97.7%
Brasilsaúde Cia de Seguros	1.4%	99.1%
Itauseg Saúde	0.9%	100.0%
Salutar Saúde Seguradora	0.0%	100.0%

Brokers and Bancassurance Dominate Distribution

By law, in Brazil, insurance companies cannot distribute their products directly; there must be an intermediary involved in all insurance purchasing transactions. Although product distribution was traditionally done through independent brokers, the surge of individual life insurance, annuities and retirement savings products resulted in bancassurance as a solid means of distribution. This movement helped several bank-affiliated life and pension companies to strengthen their market position and is now supporting their property and casualty affiliates in diversifying their sales channel strategy. Independent brokers, however, dominate the distribution of property and casualty, group life, group personal accident, as well as healthcare insurance products.

Whereas the success of bancassurance as a general insurance distribution channel is still uncertain, its considerable importance in the *capitalização*, life insurance, and pension segments as a distribution alternative is demonstrated by the concentration of the segments' premiums and deposits in bank-affiliated companies.

Brazilian insurers are increasingly seeking incremental growth by extending their distribution reach and by turning to mass marketing – credit cards, utility companies, internet, telecommunication companies and others. That said, bancassurance and independent brokers will continue to be the predominant distribution channels in Brazil, but the use of alternative channels should grow, particularly as the less affluent increase their purchasing power.

Notwithstanding the reduction in the market's overall loss ratio, the rising level of the brokerage and commission ratio – partly demonstrating the rise in sales through mass marketing, which traditionally has low levels of claims and high commissions – tempers the efficiency of the market. This is because pressures to reduce rates have been steady, and they can lead to a reduction in control of the local companies over pricing. Moody's expects that pressure to reduce the cost of delivery of insurance products will exert itself, perhaps leading to consolidation in the independent brokerage market, as has occurred in other markets.

Financial Review

Investment Concentration Tempers Asset Quality

Investments of the Brazilian insurance companies are highly regulated and monitored by SUSEP and are mainly composed of Brazilian government bonds. Insurers' policy reserve liabilities are effectively required to be funded on balance sheet with government bonds; capital funds, in turn, can be invested in a broader array

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of investments, albeit also with limitations. The absence of a deep market for structured securities (e.g. mortgage- and credit card-backed) or for relatively high-grade corporate debt is also a constraint to the overall quality of the local insurers' assets. The concentration of investments in Brazilian government bonds, currently rated Ba1 and deemed to have substantial credit risk from a global perspective, is a credit weakness of the local insurance companies relative to insurers in more developed markets. However, when considering the importance of the Brazilian government bonds to local investors, both the insurance and *capitalização* companies have fairly good balance sheet liquidity – which is also demonstrated by the satisfactory coverage of policy reserves with cash and investments, at industry averages of 1.2x and 1.4x, respectively. Furthermore, few lines of business are confidence-sensitive implying that liquidity risk is modest, and premium revenues tend to be highly stable.

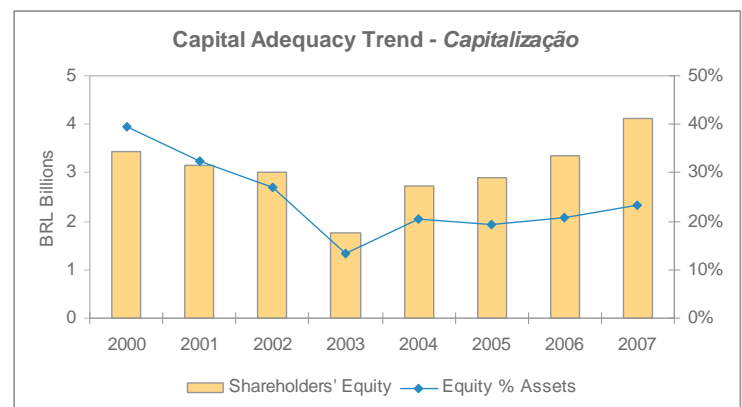
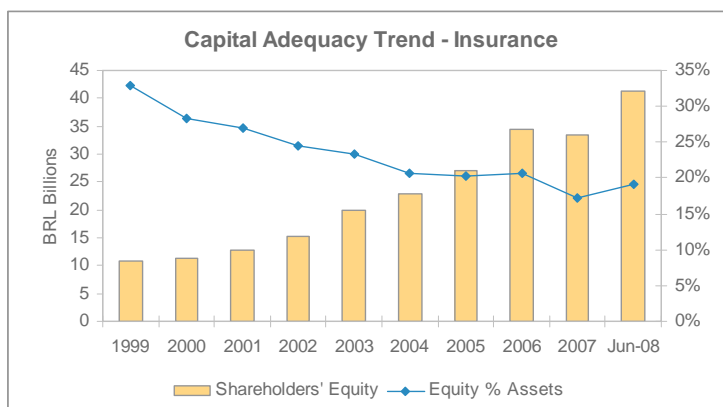
For some deposit liabilities – such as pensions, annuities and *capitalização* –, liquidity and asset-liability management are particularly important. As noted previously, though the current economic environment should lessen overall liquidity, Moody's believes that the Brazilian insurance sector is well-positioned to face the effects of greater stress scenarios. Additionally, given that these businesses are dominated by bank-affiliated insurers, we consider it a credit positive that these companies have in-house expertise as part of their banking operations that they can apply to the insurance operations, as well.

Although the current investment restrictions have proven to be somewhat effective in view of the current financial turmoil – given that the local insurance companies have not been as affected by investment losses as some insurers abroad, particularly life and pension companies – Moody's expects that, in time, insurers' investment choices should broaden, and regulatory solvency margin guidelines could become more sophisticated – in support of a greater diversification of asset classes –, as they are enhanced to consider asset and investment risk factors.

Investing in government bonds to the exclusion of most other instruments limits portfolio risk-return characteristics and carries a concentration exposure to sovereign default risk. That said, Moody's believes that within such constraints, Brazilian insurers' investments are of generally good liquidity.

New Solvency Requirements Likely to Strengthen Capital Adequacy

Insurance capital in Brazil has grown considerably over the past five years. However, overall capital adequacy has been worsening, as insurers' operational leverage – measured by gross premiums and reserves relative to shareholders' equity – increased over that same period to 6x at year-end 2007 (compared with 4.4x in 2003), and, in the same period, the equity-to-assets ratio decreased to 17% from 23%.



The Brazilian insurance regulator's decision to refine the local solvency margin calculation – calling for underwriting risk charges to primarily general insurance lines, not previously incorporated – has raised the minimum capital requirements for the Brazilian insurance companies. As a result, companies will need to raise their current levels of capital to comply with the new rules.

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Thus far, several companies have already raised their capital levels, mostly through contributions from shareholders. That said, Moody's expects that overall further capital will be injected in the companies, hence improving their capital adequacy, as local players seek premium growth and internal capital generation may not be sufficient to offset the additional underwritten risk.

Moody's also expects the solvency margin rules to be refined further to take into account a greater variety of risk factors, such as, among others, credit, asset and reinsurance risk. The latter is particularly important with the opening of the reinsurance market in 2008. New solvency margin rules for pensions and annuities are expected to be issued in the near future, which Moody's views favorably from a credit perspective.

Aside from sovereign-related investment risk, the Brazilian insurers generally operate in a relatively low-risk environment. For example, catastrophe exposures – such as earthquakes and hurricanes – are relatively benign in Brazil, as compared to seismic risks affecting insurers along the Pacific coast or windstorms in the Gulf of Mexico. However, Cyclones, floods, droughts and hailstorms can occur in the country and, therefore, catastrophe risk should not be completely ignored.

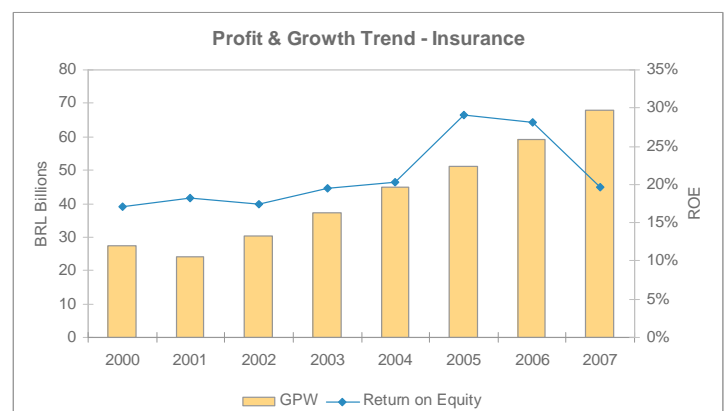
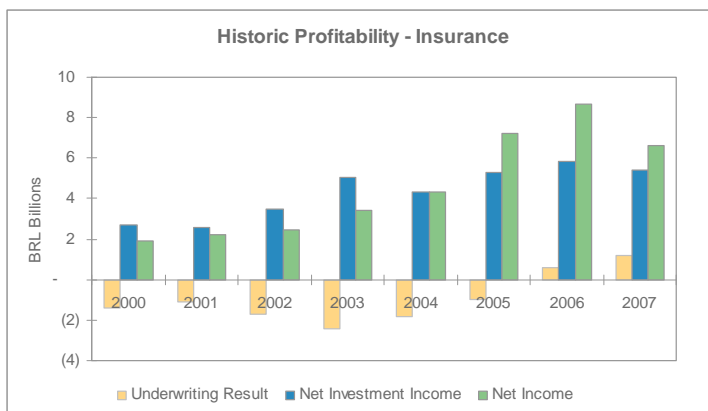
Moody's views the Brazilian insurance sector, as represented by its leading groups, as generally being appropriately capitalized for the risks being assumed. However, capital levels vary considerably among companies, and this is particularly noticeable in the *capitalização* segment.

Underwriting Profits to Help Companies Cope with Earnings Pressures

Brazilian insurers and *capitalização* companies have been enjoying exceptionally strong profitability in recent years. In 2007, insurers' five-year average return on equity was 23% and *capitalização* companies were at 41%. The Brazilian companies' total return on investment portfolios has historically supported overall earnings. This trend, however, has been shifting, largely because of the declining interest rate environment in Brazil over the past five years and much improved underwriting results. Companies are now focusing their efforts on strengthening their underwriting policies and control, and the insurance market's combined ratio has improved to 96.2% in 2007 from 112.3% in 2003.

Moody's expects that Brazilian insurers will continue to operate profitably in the current economic environment. However, the following market developments should pressure earnings in the near term: 1) the increase in the social contribution tax (CSLL) to 15% from 9%; 2) for healthcare companies, the greater number of mandatory covered procedures, coupled with the time lag until adjusted rates flow through earnings; and 3) more intense price-competition – particularly in the general insurance lines of business – as companies seek greater market share.

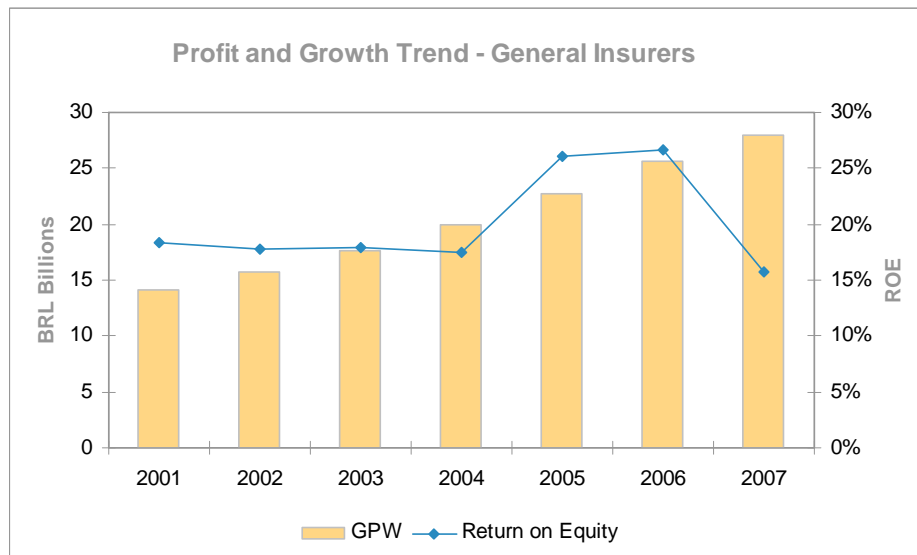
The government's decision to halt the monetary tightening cycle, as well as the expected continued slow-down of the Brazilian economy should lead to further reductions in interest rates. As a result, the local insurance companies' profitability could be pressured further, as investment income will likely decline.



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General Insurance

The Brazilian general insurers have been consistently improving their underwriting policies, reducing the overall loss ratio by nearly 900bp over the past five years (57.9% in 2007) and posting underwriting profits for the first time in that same period, with a combined ratio just below 99%. The recovery of, and increased focus on, underwriting results have not come at the expense of market growth; gross premiums in the general insurance segment have expanded, on average, 12% annually over the past five years. We note, however, that the general insurers' earnings have been hurt by the reduced returns on their investments, which has led to a decline in overall profitability, as measured by return on equity (16% in 2007 compared with 26% in 2006).

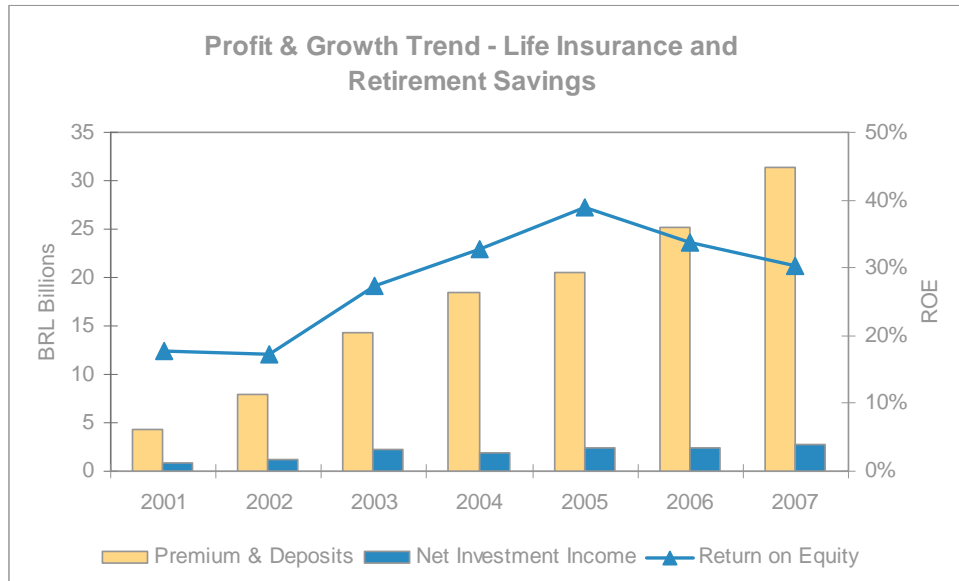


The general insurance segment in Brazil is expected to alter more significantly in the next few years as a result of the two previously mentioned changes in the overall structure of the market – the opening of the reinsurance market and the new solvency margin regulation. The former may not necessarily have a near-term direct impact on profitability, but longer-term may lead to greater variability among general insurers' underwriting results. The latter should reduce the market's return on equity to some extent because general insurers will need to retain a larger capital base in the operating units (which will also reduce their ability to distribute dividends to shareholders).

Life Insurance and Retirement Savings

The life and retirement savings companies in Brazil have sustained very strong profitability. These companies' earnings have been highly supported by solid operating results, a result of relatively high plan administration fees (market average of about 3% of total deposits and contributions) and investment fees (on average, 2% of invested amount).

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Minimum rate-level guarantees and more aggressive mortality tables have been offered by some life insurance and retirement savings companies as a way to gain market share. This practice has not yet harmed companies' financial performance, given that the Brazilian retirement and annuities market, in general, remains largely in the accumulation phase. However, we note that this more aggressive approach could impair long-term earnings and capital.

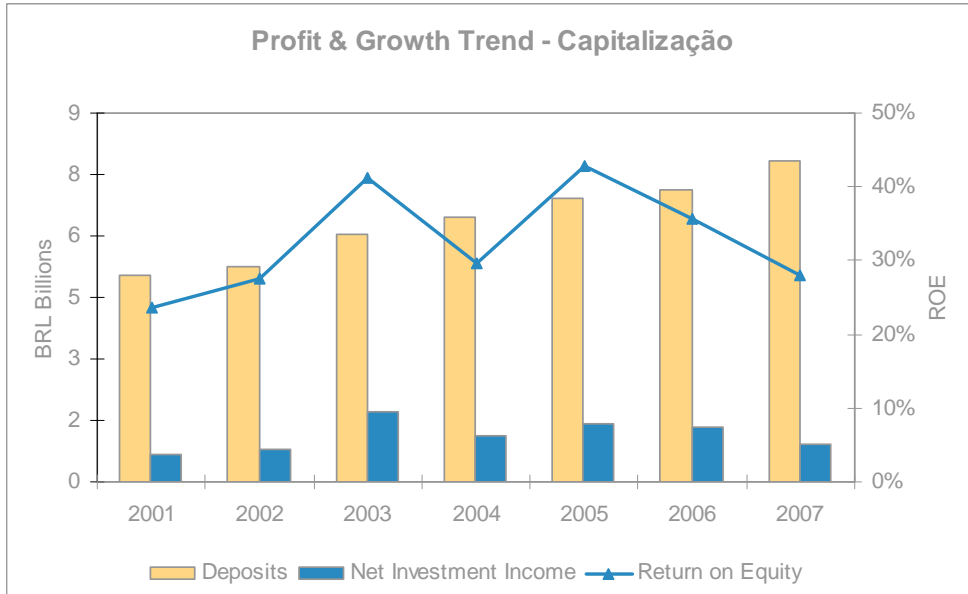
Moody's expects that the local life and retirement savings companies' solid profitability will generally be sustained. That said, their earnings will likely be negatively affected by lower interest rates, as the government tries to tackle the country's economic deceleration, as well as by possible reduction in pension plan fees to attract more deposits from current and prospective participants.

Capitalização

Profitability of the *capitalização* companies remains very good. As with the other segments of the Brazilian insurance market, overall net income has been pressured by the reduced investment yields in recent years. That said, the improving underwriting results – BRL 379 million in 2007 from a loss of BRL 26 million in 2003 – has mitigated the impact of the decline in net investment income.

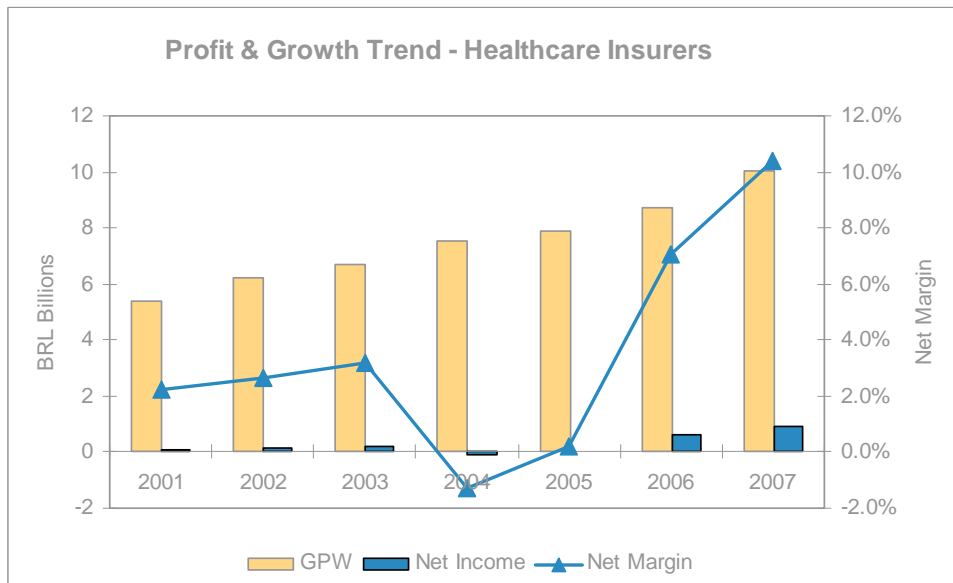
Moody's considers it positive that the major companies in this segment are either affiliated with banks or have asset management functions and expertise within the group because the primary source of earnings in this sector derives from investments. We expect that the *capitalização* companies will sustain solid levels of profitability in the near and medium term – although pressured by the declining interest rates – largely because they will maintain focus on underwriting results.

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Healthcare

Following losses caused by individual/family policies premium rate deficiencies in 2004 and 2005, the Brazilian healthcare insurance companies have rebounded and have improved their reported earnings. This trend has been led mainly by the recovery in profitability of the larger companies – Bradesco Saúde and SulAmérica Saúde – which have been able to reduce their exposure to individual plans. This improving trend is also helped by the development of more sophisticated medical cost-control measures, as well as more rigorous actuarial and underwriting policies. For example, healthcare insurers have restricted the inclusion of certain family members as dependents in the policies (e.g. parents and grandparents) and have been establishing additional reserves in their balance sheet (e.g. premium deficiency and “remissão”).



The recent resolution expanding the number of mandatory procedures to be covered will likely lead to a decline of the Brazilian healthcare insurers' profitability near-term, as it may be difficult to estimate the costs associated with these new coverages. Additionally, as previously mentioned in this report, the Brazilian medical insurers may encounter some difficulty in adjusting premium rates to the necessary levels in the near term and, as a result, will probably face timing and lag risks.

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Because the government dictates the rate increase levels for individual and family plans, healthcare companies may try to compensate for these losses through the less restrictive group policies in order to meet their target loss ratios. This could lead to a greater customer turnover, and insurers with little or no individual/family plans in their portfolio will be able to provide more attractive terms to the group clients and grow in this more profitable market niche.

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Moody's Related Research

Insurance Statistical Supplement:

- Brazil Insurance Industry, April 2008 (107908)

Special Comment:

- Opening of the Brazilian Reinsurance Market – A New Beginning, April 2008 (108874)
- Mapping Moody's National Scale Ratings to Global Scale Ratings, December 2008 (106396)

Rating Methodology, Insurance:

- Moody's Global Rating Methodology for Property and Casualty Insurers, July 2008 (108885)
- Moody's Global Rating Methodology for Life Insurers, September 2006 (98207)
- Moody's Global Rating Methodology for Reinsurers, September 2007 (104453)

Rating Methodology, Other:

- Piercing the Country Ceiling: An Update, January 2005 (91215)
- A Guide to Moody's Sovereign Ratings, December 2008 (98177)

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