Brazil
Special Report

Brazilian Insurance Sector:
Annual Results and Prospects

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Introduction

The Brazilian insurance market continues to be the largest in Latin America, with a total of BRL96.2bn in premiums written in 2008, followed by Mexico, Argentina and Colombia. Despite its low contribution to GDP (only 3.3% in 2008), a time of regulatory transition and deterioration in the macroeconomic environment in the short term, it still presents significant potential for greater development once a consistent recovery in economic growth begins.

The bancassurance process has predominated in the market, alongside the strong presence of large national financial conglomerates, with notable participation by the main foreign insurance and reinsurance groups active in Brazil. The growth of the Brazilian market has been favoured by greater economic stability and the increase in corporate and personal incomes, which has altered the population's consumption and savings habits. Parallel to this, Fitch Ratings observes that the cautious advances in the regulatory framework and the effective breakup of the IRB-Brasil Resseguros (IRB) monopoly in the reinsurance market in 2008 are expected to bring progressive benefits and modernisation to the industry in the medium and long term. However, in the short term, the agency expects sector performance to be affected by the slower resumption of development, due to deterioration of the investment environment and the economy arising from the global financial crisis, and the effects of smaller financial gains due to the effects of declining interest rates, which are expected to negatively affect insurers' earnings. To mitigate these effects, insurers have accelerated their search for greater operational efficiency, reorganising their main processes and controlling supplier costs, and streamlining their underwriting models. Fitch also expects competition to intensify in some segments, including some that are important, such as pension funds, putting further pressure on the insurers' earnings generation.

Prospects for the Industry

The Brazilian insurance industry continues to have concentrations in its main lines of retail products and a small number of players. The 10 largest insurers accounted for 78.0% of the premiums written in 2008, most of them affiliated with large financial conglomerates. Retail insurance products, mainly those that present more synergy with banking products, continue to dominate the industry. In recent years, life insurance with non-qualified long-term savings products (known as VGBL, similar to the US 401k plan but structured for employees not formally registered) has had the greatest dynamism, as shown by Table 1, driven by tax incentives and greater concern among the population regarding retirement income, while traditional pension plans have lost importance, due to their lower actuarial adequacy and returns during the financial crisis. The VGBL product, however, will tend to have slower growth due to falling incomes; this is reflected in the segment's figures for May 2009. This segment had growth of 12% compared with the same period in 2008, well below the average for 2003-2008 (26.7%).

The insurance industry's net premium gains, including those of the health insurance sector, had good growth of 14.0% in 2008, in line with 2007. Meanwhile, the most recent market data show deterioration in the real rate of sector growth in the short and medium term, due to the more significant decline in the volume of business and investments arising from the worsening of the macroeconomic environment. At end-May 2009, total industry premiums growth (excluding health premiums data, which was not available at the time of writing) was 7%. However, Q109 figures

confirmed lower activity, as all segments' premium growth was 7.4% on Q108. This growth was well below the average of 13% per year for 2003-2008. Market estimates point to nominal growth in total insurance industry premiums of only 5% for 2009. In real terms, this is expected to be close to zero, reflecting expectations of a slight contraction of GDP. Nevertheless, the market projects growth similar to the average of recent years, which, in Fitch's opinion, will only occur with an economic recovery and more consistent investments. Mass products tend to achieve better performance than those that rely on more capital-intensive segments, such as large risk lines, which are more dependent on the business environment and significant investments.

Table 1: Premiums Written and Contributions by Segment (%)

Business lines	Q109	2008	2007	2006	2005
Auto/RCF [a]	15.9	16.0	16.1	18.1	18.0
Property and casualty	17.0	17.7	16.8	16.5	15.9
VGBL	23.4	24.5	23.9	20.8	18.0
Health	12.2	11.7	12.1	12.4	13.0
Pension funds	8.7	8.3	9.4	9.8	12.0
Life	13.4	12.6	12.5	12.8	12.6
Capitalisation	9.3	9.4	9.3	9.7	11.0

[a]Optional civil liability
Source: Fitch

Auto premiums, the second-largest line in Brazil, whose margins have repeatedly come under pressure from the effects of competition since 2004, reported significant expansion of 13% in 2008, after low nominal growth of 2% in 2007, due to lower prices. This growth is mainly explained by the large increase in new vehicles sold during the year, despite the strong contraction in Q408 due to the global financial crisis, and to changes in the underwriting policies adopted by a large part of the market to restore margins by increasing prices. The tax incentives implemented by the government from December 2008 had a positive impact, with some signs of a partial recovery in the pace of auto sales. This could attenuate the potential effects of economic deterioration on the generation of premiums in this segment during 2009. In May 2009, the auto insurance market reported good growth of 10% compared with the same period in 2008, but this is not expected to last until the end of the year. Fitch also expects the maturing of a material proportion of insurers' investments in their underwriting parameters to benefit the market's loss controls and profitability in the medium and long term.

In the health insurance segment, collected premiums issued had adequate growth of 10.1% in Q109, similar to that registered in 2008, largely due to the performance of the group health portfolio, given the lower dynamism in the individual health segment, arising from the effects of greater regulation. Fitch expects limited development in this market in the short term and even a slight deterioration in loss ratios, due to increased medical costs, strongly related to exchange variations. Meanwhile, the agency believes that, given the low penetration of the business and dental health segments, these niches can attenuate the effects on the segment due to their potential for growth in the medium and long term. The agency also observes that consolidation in the health segment will maintain its slow pace, despite greater regulatory pressure on health operators and insurers to make control and capital criteria more uniform.

The capitalisation product, a credit instrument that combines in its plan the formation of savings with a lottery feature distributing prizes, reported good growth (8.4% cumulatively to May 2009), above the average observed in other products. In part, this performance is due to this product having more appeal in a scenario of lower interest rates, as its profitability compared with that of other investment products tends to be less penalised.

- Performance is consistent, with high financial gains in the past tending to come under pressure from greater competition and changes in sector profile

Operational Performance

Significant technical losses in the past derived from recent streamlining of underwriting processes for the main insurance segments. Technical losses have therefore declined substantially in recent years, as shown in Table 2, despite the trend for deterioration in the short term in some lines, especially the auto segment and obligatory insurance of personal damage caused by automobiles (DPVAT). The conclusion of the process to strengthen technical reserves and introduce greater risk selectivity has also benefited the overall claims ratio, especially in the health, property and casualty, and life lines.

Table 2: Loss Ratio for Principal Lines (%)

Business lines	Jan-May/09	Q109	2008	2007	2006	2005
Auto/RCF[a]	67.1	67.9	66.0	63.0	63.3	68.9
Property and casualty	40.3	46.3	41.4	40.6	43.3	45.9
Health	n.a.	78.7	81.0	83.0	84.0	90.0
Life and VGBL	34.0	33.6	38.6	45.1	49.0	51.7
DPVAT	87.2	86.0	82.0	81.0	82.9	72.5
Market total	n.a.	59.8	69.1	73.4	73.4	77.0

[a]Optional civil liability

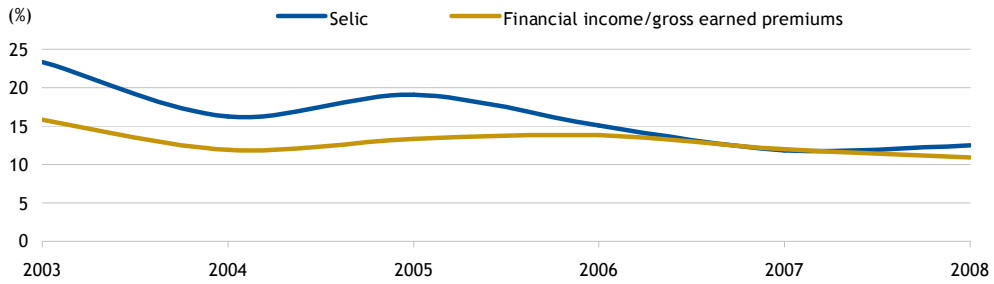
n.a. – Not available
Source: Fitch

Insurers continue to focus on operational cost controls, which have collaborated in producing lower and improved combined and operational ratios (averages for the 10 largest insurers in 2008 of 96% and 84%, compared with 100% and 86% in 2007 and 111% and 87%, respectively, in 2003). These costs are becoming increasingly crucial in operational performance and differentiating insurers in the medium and long term, especially in an environment of lower interest rates. They represented, on average, about 31% in 2008 (24% in 2007) of the premiums retained by the main insurers affiliated with large banking conglomerates. For the other large independent insurers, this ratio was 44% (42% in 2007). This demonstrates the importance of the large banks' ample network of distribution channels to obtain appreciable scale benefits, which represents an important competitive advantage for their insurance companies. Fitch considers the increase in strategic agreements between the principal market insurers and service providers to be a trend that should enable greater control of losses. In the short term, the agency expects a slight deterioration in combined ratios due to the slower expected growth and greater cost pressures, which tend to be mitigated for insurers that achieve greater efficiency in their processes.

Financial gains are becoming less important compared with premiums earned, as in 2008, when this ratio was 11% (13% in 2007 and 16% in 2003) due to lower revenue derived from falling interest rates, as shown in Chart 1. In recent years, these lower earnings have been compensated for by the gain in operational efficiency observed in the largest insurers, which is reflected in the decline in the combined ratio, to 96% in 2008 from 109% in 2003. Despite the greater pressure of competition and smaller financial gains, the large insurers have been able to maintain good profitability, 25% on average, in recent years. Fitch does not expect this trend to change in the medium and long term, despite the greater deterioration expected in the short term, especially in 2009, due to the economic crisis and declining interest rates.

The insurers assessed by Fitch are not expected to experience a substantial deterioration in their credit profile in the short term, given their conservative underwriting policies, good cost controls and good market positioning.

Chart 1: Selic X Financial Income/Gross Earned Premiums



Source: Fitch

- Assets supporting technical reserves adhere to regulated investment standards and are highly concentrated in government securities

Risk Management

The insurance industry's assets that support its technical reserves continue mainly to reflect adoption of the general investment principles contained in the conservative prudential rules defined and monitored by the Superintendency of Private Insurance (Susep). For pension fund entities, for example, to date, greater protection for the assets of these plans has yet to be effectively regulated, mainly in relation to operator solvency problems. For example, in the event of bankruptcy or extra-judicial liquidation, the priority of these creditors' assets remains low, instead of being granted effective privileges compared with an operator's other creditors.

At the same time, Fitch notes that companies in the sector follow very strict limits in their portfolio. Applications are generally concentrated in fixed-income assets, with few issuers and instruments, such as bank Certificate of Deposits (CDs) and federal government paper, which continued to correspond to more than 95% of the total. Susep continues to restrict the investment of resources in foreign securities, which, despite limiting asset and liability management in some cases, has in a way avoided the impacts of a significant depreciation in the market prices of securities issued abroad. The insurers also have a low exposure to variable equity securities, which accounted for only 2% of their applications at end-Q109 and 10% of the insurers' equity. These assets are used mainly to back part of the open pension fund plans and the still minimal portion allocated to real estate. Compared with other Latin American countries, the exposure to shares is similar. The exception is Peru, where the percentage allocated to shares is higher, accounting for 7% of financial applications and 32% of equity.

Reinsurance

Fitch considers the gradual opening of the reinsurance market to be very positive, even though it has progressed less than in other Latin American countries, despite this market's appeal, as shown by the registration of more than 60 reinsurers. In Brazil, the market opening introduced new possibilities for protection strategies, previously solely concentrated in proportional contracts, with conditions and prices determined by the IRB. Given the strict technical limit for Brazilian insurance company risk retention, equivalent to 3% of adjusted equity, the insurers were compelled to cede almost all their large risks and follow the underwriting policies determined by the IRB. With the opening of the market, non-proportional contracts, widely used in other countries, can be established, opening the possibility for more sophisticated reinsurance strategies and greater retention by the insurers, which rose to 95.2% in 2008 (93.9% in 2007 and 87.5% in 2003).

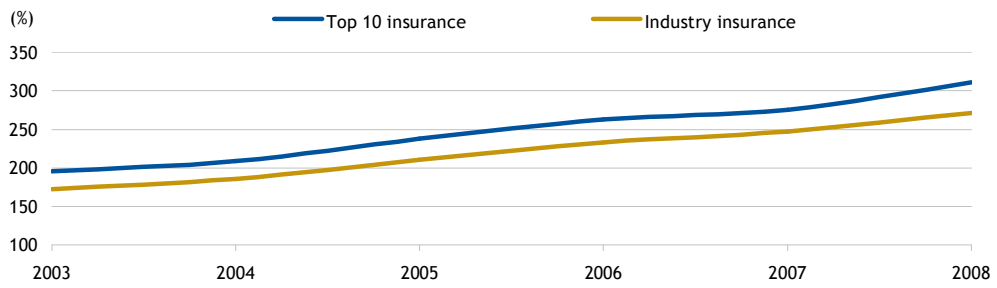
In recent months, international reinsurers have shown greater aversion to risk, reflecting the crisis environment and repositioning of their portfolios. As a result, the business has remained concentrated at the IRB, which underwrote 85% of the market reinsurance premiums in 2008. This trend is expected to continue in the

short term, despite the good success experienced by the recently constituted local reinsurers, which, in some cases, have achieved growth above expectations. There was also greater flexibility for occasional reinsurers, which are subject to less Brazilian regulation, to accept risks to enable certain projects, especially in the petroleum sector. In the long term, Fitch expects greater price deregulation and the end of IRB's obligatory acceptance of all risks ceded by the industry to benefit the insurance market, with improvements in processes, underwriting controls and insurer selectivity, generating lower costs and better conditions for policyholders.

Reserves and Other Liabilities

The constitution of technical reserves by most insurers largely reflects the determinations of prudential rules. These will tend to change, not only because implementation of Solvency II is expected on schedule in 2010, but also due to the industry's progressive modernisation through improvements in underwriting controls, risks and actuarial calculation standards, as observed in other emerging or developing markets. This explains the recent growth of technical reserves to support a greater range of risks incorporated, as shown in Chart 2. The largest insurers have, on average, larger reserves compared with the market, due to their greater participation in the life and pension fund segment. The more accentuated growth in life and pension fund reserves mainly reflects the more reserve-intensive nature of a product that is still in the accumulation phase, and the sales boom that began in 2000.

Chart 2: Technical Reserves/Net Earned Premiums



Source: Fitch

Another trend in the Brazilian system is the growing volume of contingencies, even though they still represent only a small proportion of the insurance companies' liabilities. These are constituted to meet tax and labour demands, as well as for tax credits, and in part reflect the national companies' growing tax burden and the lengthy debate about legal issues in relation to contingencies.

- The leveraging profile will change in the long term with greater business development and new prudential rules

Capital and Leveraging

During 2004-2008, the insurance industry's capital base grew significantly, with average growth rates of 23% per year, benefiting from greater profitability. As a result, despite the sector's higher leverage, it remained under control during the period, at about 5x-6x equity.

The capital rules adopted in 2008, signalling the beginning of convergence with the rules of Solvency II, determined a new level of minimum capital. It incorporates a fixed capital base of BRL15m (BRL7.2m before the new rules), plus a variable portion based on actuarial premises that consider the underwriting risks. The regulator has allowed a period of four years for gradual adoption of the new capital levels and will monitor deficient institutions through solvency plans. The economic crisis is expected to make it difficult for some insurers to attain the minimum capital levels, as their performances are projected to fall short of the average of recent years. Due to the economic environment, Susep is also expected to delay the

incorporation of other relevant risks, such as credit, operational and market risks, into the institutions' required regulatory capital, which Fitch would consider important for a better assessment of the adequacy of the companies' capital structure.

The agency also expects still greater consolidation of the sector and of the smaller and medium-sized players, whose business niches will not be so profitable in this new regulatory environment. It also foresees that the well-capitalised insurers will have a competitive advantage in a scenario of greater competition and macroeconomic deterioration. Some foreign insurers, and some national ones, are still aiming to sell parts of their business in the short term, as some did up to Q109, so as to specialise in certain niches and, in the case of foreign insurers, to strengthen the capital of their head offices.