Brazil
Special Report

Brazilian Insurance Industry: Annual Results and Prospects

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Introduction

The Brazilian insurance market is the largest in Latin America and, despite its low participation in GDP (only 3.3%), presents significant potential for greater development at a time of regulatory transition and expected consolidation in the industry.

Since 2003, bancassurance has dominated the market, and the national financial conglomerates continue to enjoy a strong presence, alongside the relevant participation of the main foreign insurance and reinsurance groups active in Brazil. As well as benefiting from the low exposure to large natural catastrophes, the growth of the Brazilian market has been favoured by greater economic stability and an increase in corporate and personal incomes, both of which have been important business growth drivers in Brazil which have altered the consumption and savings habits of the population. Parallel to this scenario, Fitch Ratings notes that the cautious advances in the regulatory framework and the effective break-up of the IRB-Brasil Resseguros (IRB Brasil Re) monopoly in the reinsurance market that began in 2008 are expected to bring progressive benefits and modernisation to the industry in the medium to long term.

Prospects for the Industry

The Brazilian insurance industry is going through a consolidation phase, driven by the prospect of improved insurer credit profiles and the progressive implementation of new prudential rules and the opening of the reinsurance market. Fitch expects that the participation of more reinsurers in the market and the possibility of greater price bargaining and new product offerings will lead to the adoption of more sophisticated strategies in the medium and long term, particularly if the insurance companies continue to improve their underwriting and control standards.

In the agency's view, the insurance market is expected to maintain consistent growth in the short and medium term, even though there may be a greater impact on prices in those areas where the competition has been most intense. In addition, the agency believes that more significant changes in insurers' performance will depend not only on market behaviour, but also on improvements in the companies' practices. Continued strengthening of reserves and capital bases, due to the adoption of new prudential rules, is expected to provide a greater cushion for the industry's transition and consolidation during the period. Fitch believes that the sector will benefit from these developments, as well as from the benign environment of greater investment in infrastructure and sustainable economic growth, which continues to increase the population's purchasing power.

- Economic stability, maintenance of fiscal discipline and increased international reserves have reduced Brazil's vulnerability to external shocks

Economic Environment

Since 2003, the Brazilian economy has resumed a positive growth trajectory, which culminated in the upgrade of Brazil's sovereign Foreign and Local Currency Issuer Default Ratings to investment grade in June 2008. The ratings upgrade reflected the extraordinary improvement in Brazil's external and public sector accounts, which significantly reduced the country's vulnerability to external and exchange shocks and strengthened its macroeconomic stability and the prospects for growth in the medium term. The Brazilian authorities have been able to maintain a track record of commitment to low inflation and a primary budget surplus, factors that dissipate previous concerns about medium-term fiscal sustainability. The upgrade in Brazil's

ratings to investment grade is also supported by a diversified economy, with high value added, and relative political and social stability.

Brazil became a net external public sector creditor for the first time in 2008, due to the government's capable management of its debt and the significant increase in international reserves. Its policies have gained greater credibility and the improved profile of government debt has reduced 'fiscal dominance' of monetary policy decisions, making public sector accounts less vulnerable to exchange shocks and promoting belief in inflation targets and the operational freedom of the Central Bank of Brazil. The latter, in turn, has not hesitated to increase interest rates to combat inflation and contain inflationary expectations and it continues to demonstrate fiscal discipline by reaffirming its primary surplus goals.

Brazil's current growth cycle has been the longest in the last 20 years and the country's recent performance has helped it close the gap between its average five-year growth rate (4.5%) and that of other countries classified in the 'BBB' category (5%). The formalisation of the economy, credit expansion and greater certainty regarding macroeconomic variables (due to the greater discipline in the policies adopted by the government) have led to increased consumption and investments in Brazil, enabling the country to grow at a more accelerated and stable rate than in the past.

At the same time, Brazil's ratings continue to be limited by structural weaknesses in its public finances, the gross public debt burden, an unfavourable (albeit improving) domestic debt structure and the extremely slow progress of structural reforms. The reduction of these limitations through reforms could unleash the economy's potential and strengthen public finances, ultimately benefiting the country's ratings. However, persistent political slippage that undermines the credibility of the current structure could negatively affect Brazil's ratings.

- Sector experiencing progressive expansion, influenced by the presence of large national and international financial conglomerates
- Effective break-up of the reinsurance monopoly and advances in the regulation of insurance and reinsurance is expected to benefit the market in the medium and long term

Sector Structure

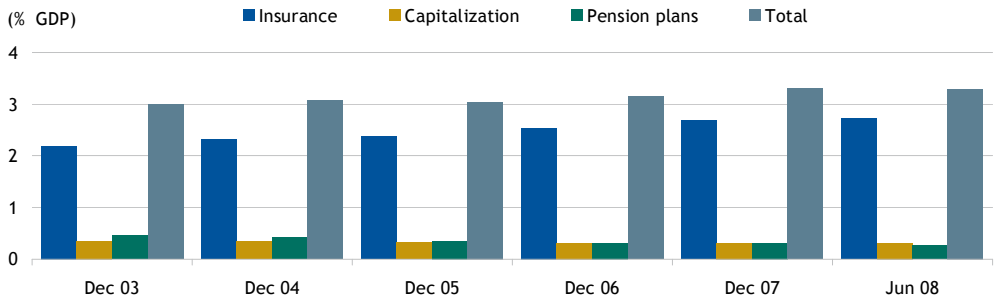
The private insurance market encompasses general insurance products (divided between general lines, life and health), open pension plans and capitalisation. The latter is a unique credit instrument which combines savings plans and a prize lottery. These products are generally distributed through bank sales channels, as is the case in other Latin American countries, and via a wide range of brokers. In Brazil, the use of brokers is obligatory by regulation, so they will remain an important feature of the industry.

Since its creation in 1808, the activities of the insurance industry have been strongly regulated by the local authorities. Its operations are subject to the directives and regulations established by the National Private Insurance Board (CNSP), which also regulates reinsurance activities. The CNSP has undergone several changes since its creation in 1996, and currently comprises representatives from the Finance, Social Welfare and Assistance, and Justice Ministries, as well as other federal regulatory bodies, such as the Private Insurance Superintendency (Susep), the central bank and the Securities and Exchange Commission (CVM). Susep is currently responsible for carrying out the CNSP's policies, the control and supervision of insurance activities, open private pension plans, capitalisation and reinsurance. Insurance related to social welfare — which is growing in Brazil — continues to be regulated and supervised by other bodies, with progressive (although slow) advances being made by Susep to share these activities. In health insurance, the insurer must be a specialist health insurer; regulation and supervision of this sector has been the responsibility of the National Supplementary Health Agency (ANS) since 1999. Unemployment insurance is totally subordinate to the Ministry of Labour, while retirement, pensions and labour-related accident insurance have been subject to regulation by the Ministry of Social Welfare and Assistance (MPAS) since its constitution in the early 1990s.

Given the way the market has developed over the last two decades and considering the current gap between Brazilian and international practices, the regulators have formulated an ambitious plan to develop the sector, which aims to stimulate competition and encourage more market-oriented policies. Control systems, the degree of transparency in the information reported and prudential policies and rules have been progressively improved, mainly after greater participation of foreign capital was authorised in 1996 and after IRB Brasil Re's 50+ year monopoly in reinsurance was effectively broken in 2007. Currently, the insurance industry's regulatory structure is in transition. The focus of supervision is directed at risk and on honing solvency rules and monitoring changes in the market environment, with greater autonomy being given to the institutions. This plan aims to transform Fenaseg (the Brazilian association of insurance companies) into a confederation that will coordinate the strategies and common policies of the different insurance and reinsurance niches and the new federations that are being created, such as the general insurance federation (Fenaseg), the life and private pensions association (Fenaprevi), and the supplementary health (FenaSaúde) and capitalisation (Fenacap) groups, as well as re-define the activities of the insurance and brokerage company trade associations. In Fitch's view, the adoption of practices that are more market-oriented and the positive prospects for economic growth will be key factors in the development of the industry.

In recent years, per capita insurance consumption in Brazil has increased and the insurance market continues to demonstrate good growth potential (with a CAGR of 14% pa between December 2003 and June 2008, and gross premiums of BRL45.9m in H108, equivalent to 3.3% of GDP — see Chart 1). Despite the expectation that the insurance and reinsurance markets will consolidate in the long term, the number of participants increased between December 2003 and June 2008 due to the favourable prospects for the reinsurance segment, which consisted of some 211 institutions (119 insurers and 14 reinsurers) in June 2008 and more than 68,000 active registered brokers. The number of foreign insurers remains around 42, with their share of premiums accounting for about 27% of the industry total since 2005.

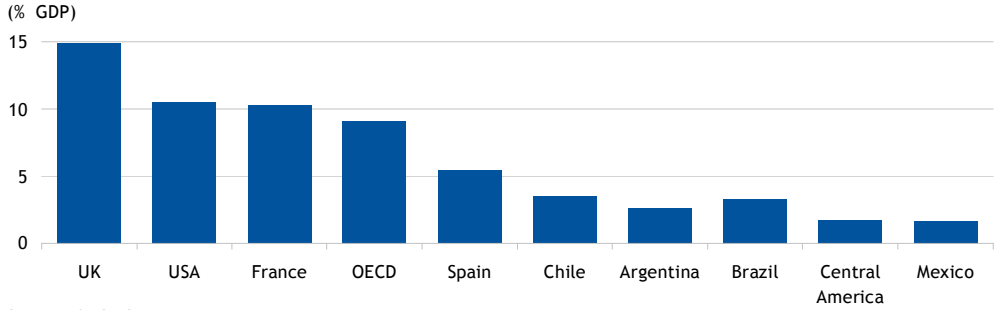
Chart 1: Evolution of the Insurance Industry



Source: Fitch

The Brazilian insurance sector remains the largest in Latin America and the Caribbean. This status mainly reflects the prospects for greater stability and the country's recent economic development, as well as the population's increased income and purchasing power, which have led to changes in savings habits. In addition, banks have achieved greater penetration of their products due to the increased supply of credit. This, in turn, has boosted the sales of insurance products, as in certain lending operations, insurance has been added. On the other hand, the level of representation in the insurance sector in Brazil is low compared with the Brazilian GDP, at around 3% to 4%, as is the case in other Latin American countries and some larger emerging markets, such as Russia and China, positioning it below the level of the more mature markets (between 7%-10% — see Chart 2).

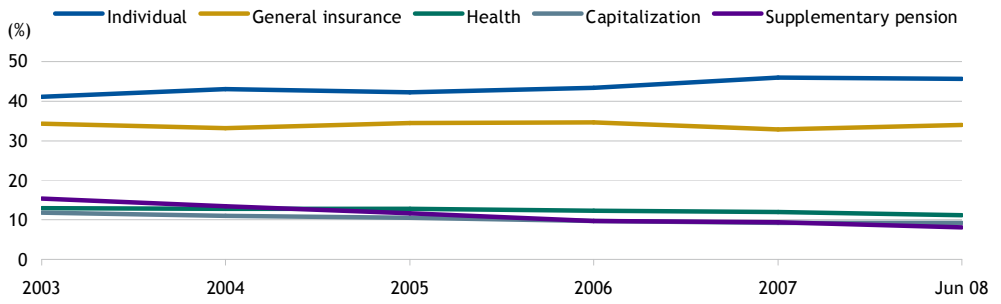
Chart 2: Premiums/GDP 2007



Source: OECD Statistics

Even so, the lack of unawareness of insurance products shown by most Brazilian people is significant, despite the larger tax incentives available in certain niches since the 1990s, such as in the life and, subsequently, pension segments. These niches have grown significantly since 2001 due to the regulation of the two best-known private pension plans in the market, known locally by the acronyms PGBL and VGBL. The latter, which is the more widely used one, grew at a CAGR of 23% p.a. between 2002 and 2007 (see Chart 3). This growth reflects the growing interest of the population in the life and pensions sectors, stimulated by the constant debate about social security reform in Brazil. The insurance market in Brazil is dominated by traditional products for individuals and corporate entities, the main product type being pensions (including VGBL), which was responsible for an average share equivalent to some 31% of total industry premiums between 2003 and June 2008, followed by the auto (17%), health (12%), life (12%) and capitalisation (10%) lines. This trend is similar to that in much of Latin America, although more concentrated when compared with more mature markets, such as Chile's.

Chart 3: Concentration by Insurance Lines



Source: Susep

In the short term, no significant changes in this profile are expected, despite expectations of greater growth in other commercial lines, in anticipation of greater economic development in the long run, a larger volume of investments and increased consumption of lower ticket products by low income individuals.

Bancassurance and product funding and distribution are also prominent characteristics of this market, especially as the latter is mainly concentrated in large insurers affiliated with banking conglomerates. The 10 largest insurers accounted for some 78% of market premiums and contributions in June 2008 (78% in 2007 and 66% in 2003); six are controlled by large financial conglomerates. The number of partnership agreements is similar to that observed in other Latin American markets, despite the selling of portfolios between large financial conglomerates during the past decade.

Obligatory Insurance

Following the implementation of Decree Law 73/1966, which created the National Private Insurance System (formed by the CNSP, Susep and other market participants), several types of obligatory insurance were instituted. The obligatory insurance covers damage, loss and ancillary liabilities, generally stipulating a minimum indemnification per event. The coverage includes:

- personal damage to commercial airline passengers and civil liability coverage for aircraft and air transportation owners;
- personal damage caused by automobiles (DPVAT) and ships (DPEM), or their cargo, to individuals, whether in transit or not;
- the civil liability of transportation companies in general;
- the civil liability of real estate construction companies in urban zones for damage to people or property;
- insurance for goods given as guarantees for loans or financing, applied to government financial institutions;
- insurance for borrowers of civil construction payments, including real estate obligations;
- insurance against risks arising from third party damage to buildings subdivided into separate units;
- insurance against fire and transportation of goods owned by corporate entities located in Brazil or transported therein; and
- insurance against export credit, when deemed appropriate by the CNSP.

Although agricultural insurance is not obligatory, it is exempt from federal taxes and enjoys specific subsidies from the Ministry of Agriculture, Livestock and Supply (MAPA) for part of the agricultural insurance premium paid by the producer to make it more affordable for all agricultural producers. In addition, the Agricultural Insurance Stability Fund (FESR) was created in 1996 using some of the proceeds of agricultural insurance and reinsurance activities and government donations in order to guarantee the stability of Brazilian agricultural operations and meet the supplementary coverage for the catastrophe risks inherent to the agricultural business. IRB Brasil Re is the current administrator of the FESR (whose equity totalled BRL408m in 2007 and BRL314m in 2006), which enables the insurers and IRB Brasil Re itself to recover a portion of their retained losses. The possibility of IRB Brasil Re creating a consortium that would guarantee and improve the coverage for agricultural risks due to catastrophic climatic events (to replace the current FESR) is currently under discussion.

Reinsurance

Up to 2007, the Brazilian reinsurance market was, together with those in Cuba and Costa Rica, one of the last reinsurance monopolies in Latin America. IRB Brasil Re was the only player authorised to both operate and exercise regulatory functions within the Brazilian industry. Although it had contacts with some 80 international reinsurers, the IRB was compelled to accept all risks ceded by the Brazilian insurance companies and, in turn controlled contract prices and centralised all retrocessions that occurred in Brazil. This situation somewhat restricted the growth of the market as there was only limited opportunity to offer better prices and new products. Reflecting the slow pace of the reinsurance market in Brazil, total premiums issued by IRB Brasil Re in 2007 amounted to BRL3.3bn, equivalent to only a small portion of the insurance industry, just 0.1% of GDP.

With the effective opening of the reinsurance market in January 2007 and the regulation of the sector from Q208, the government has created three types of reinsurers: “local”, “approved” and “occasional”.

Local reinsurers comprise those established with headquarters in Brazil as an open capital company. They are required to adhere to Susep's prudential rules. They must maintain a minimum capital of BRL60m, equivalent to USD37m, in addition to additional capital related to underwriting risks, and be constituted in Brazil. Approved reinsurers do not have to be constituted in Brazil, but need to be registered with Susep and comply with a number of requirements, such as a minimum rating and equity, and must also maintain USD5m with Susep to guarantee their operations in Brazil. Occasional reinsurers are not required to make deposits to back their operations in Brazil, but must meet requirements similar to those expected of approved reinsurers. Up to 2010, all insurers will have to offer at least 60% of their premiums to local reinsurers and, thereafter, 40%. Insurers can place their remaining premiums with approved reinsurers, but only 10% of the premiums ceded can be placed with occasional reinsurers. Occasional reinsurers will also have a very limited retrocession business, and will only be permitted to underwrite 50% of the premiums ceded by the local reinsurers.

Due to the large regulatory and capital requirements, few foreign companies have indicated a willingness to act as local reinsurers, despite some of them having been present in the Brazilian market since the 1990s. Up to July 2008, some 19 reinsurers had been licensed, with Munich RE and J. Malucelli RE to date being the only ones to become local companies, affiliating themselves with IRB Brasil Re. Despite the restrictions on their activities, most reinsurers have so far opted to operate in Brazil as approved (9) or occasional (8) reinsurers, due to the fewer requirements imposed.

Fitch considers the gradual relaxation of the barriers to entry to the reinsurance market to be very positive, despite the less opening degree of the Brazilian reinsurance market compared with other Latin American countries. In the agency's view, the supply of reinsurance contracts is expected to grow and become more sophisticated, leading to reduced prices and considerably improving the protection available to insurance companies. As an example, before the opening of the market, IRB Brasil Re only offered proportional contracts, where the risks and premiums were equally divided between the insurers and reinsurers. This situation considerably limited the activities of insurance companies that were active in the large basic risk segments, given that the technical limit of insurers in Brazil is equivalent to 3% of adjusted equity, which Fitch considers to be low. This restriction forced insurance companies to cede almost all of their risks and apply the conditions set by IRB Brasil Re, which to a large degree determined prices and commissions. 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. In addition, the greater deregulation of prices and the fact that IRB Brasil Re is not required to accept all risks ceded by the industry are expected to benefit the insurance market, with improved processes, underwriting controls and insurer selectivity translating into lower costs and better conditions for policyholders. As the new model develops, Fitch expects that in the medium and long term the government will review the market reserves applied and the restrictions imposed on reinsurers to enable a greater degree of freedom and the entry of Brazil into the international market, further benefiting the industry.

- Consistent performance; although the high financial gains of the past may be difficult to achieve in the future

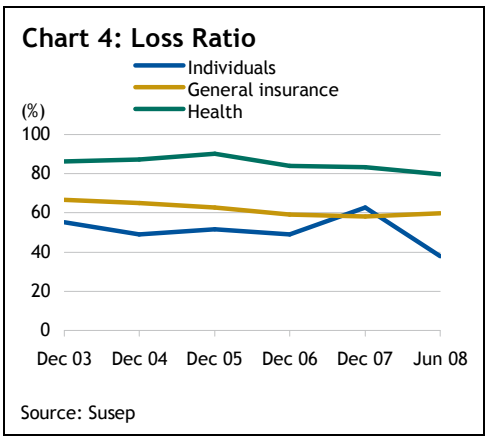
Operational Performance

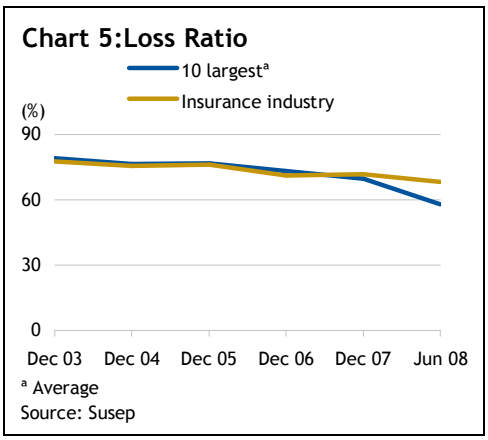
The rate of premium growth in the Brazilian insurance industry has increased in recent years, driven by the economic context and incentives to save. In Fitch's view, this is not likely to change in the medium term. The market projects growth rates of between 10% and 15% pa for the sector, with expectations for a greater increase in most of the general insurance segments (DPVAT, property, homeowner, agricultural, financial and credit risks) and the personal segment, through continued growth of the VGBL and the introduction of new plans and coverage for the life segment.

Thus far in 2008, the market has grown consistently (with an expansion of 13% for the 12 months ended H108 and 15% in 2007 and 12% in 2006), presenting positive growth in practically all commercial lines, notwithstanding the more intense competition that has affected prices in recent years, such as that seen in the auto insurance market (which grew 12% for the 12 months ended H108, compared with a low 2% in 2007 and 10% to 2006). Since 2003, the relative participation of the principal product lines has not changed significantly, except for the substantial growth experienced in the personal insurance segment (CAGR of 16% pa between 2003 and H108), mainly in the life segments, with coverage for survival and personal accident risks, among others, as well as pension plans. Some specific lines of general insurance have also expanded significantly (CAGR of 14% pa), such as the DPVAT (CAGR of 35% pa and an average participation of 3% in total sector premiums between 2003 and H108), stimulated by increased rates and growth in the fleet of new vehicles licensed in Brazil, as well as others of less importance, such as financial and agricultural insurance (respectively 30% pa and 17% pa during the same period).

Although the level of risk retention has grown slowly in the industry in general, it is still low for the most important insurance segments, reflecting the low retention level per risk defined by the regulator. In the case of the 10 largest insurance companies, retention remained high in H108, having varied between 81% and 97% in 2007 (some 73% and 97% in 2003), mainly reflecting greater capitalisation, their participation in the auto, life and capitalisation markets and greater penetration in mass products, where retention is greater.

The loss experience of the sector and the largest insurers has, in general, reflected the recent improvement in the underwriting processes in the main segments of general insurance, casualty and health. It declined more significantly up to 2006, with a fall of almost 10 percentage points in the average general insurance index between December 2003 and June 2008 (see Charts 4 and 5). In the personal insurance field, higher losses reflect the influence of VGBL, which involves the constitution of large reserves to meet the growing redemption volumes expected. Fitch further notes that the greater loss stability in 2008 and its potentially more significant decline over the long term, benefiting insurance company performance, will depend not only on the behaviour of the market, but also on competition and the effect of pricing improvements.





In recent years, insurers have place greater emphasis on controlling operating costs, maintaining them at a stable level compared with business growth and contributing to improved and lower combined and operating ratios (an average of 101% and 83% at H108 for the 10 largest insurers, versus 100% and 86% in 2007, and 111% and 87% respectively in 2003). These costs are another critical variable in operational performance and in differentiating the insurers over the medium and long terms, mainly in an environment of lower interest rates. In 2007, costs represented, on

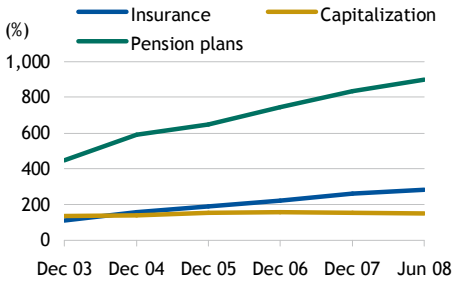
average, about 22% (27% in 2003) of the premiums retained by the principal insurance companies affiliated with large banking conglomerates. The ratio for the other large independent insurers was 42% in 2007 (40% in 2003). This demonstrates how important the large banks' extensive network of distribution channels is to achieving appreciable gains in scale, representing a considerable competitive advantage for their insurance companies.

Financial earnings declined in importance compared with premium gains up to the end of 2007, dropping to 13% in 2007 from 21% in 2003. This reflects the lower financial revenue generated by declining interest rates. This trend, however, was reversed in 2008 as a result of turbulence in the international markets, with consequences for the domestic market and new increases in interest rates. In recent years, these lower earnings have been offset by the gain in operational efficiency observed at the largest insurers, which, for Fitch, will continue to be a fundamental factor in the industry's increasingly competitive environment. As a result, despite greater competitive pressures, the large insurers continued to post strong returns, with an ROA and ROE of 4% and 26% in 2007, and 3.5% and 27% in H108. Fitch believes that this trend is unlikely to change in the medium term, despite expectations for more modest returns in the future, given the increasing competition and potential pressures on interest rates.

Reserves and Other Liabilities

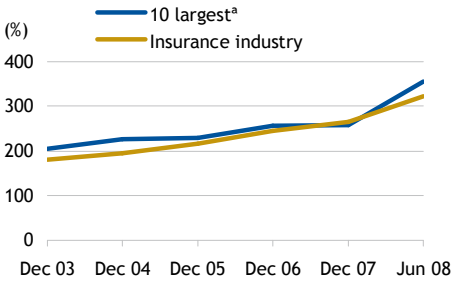
The most insurers' technical reserves basically reflects the requirements imposed by prudential regulations. These are expected to change, not only because the outlook for the new international solvency rules considers implementation of Solvency II by 2010, but also because of the industry's progressive modernisation due to improvements in the system's underwriting controls, risks and actuarial calculation standards, a fact observed in other emerging or developing markets.

Chart 6: Technical Reserves/ Earned Premiums



Source: Fitch

Chart 7: Technical Reserves/ Earned Premiums



[a] Average
Source: Fitch

This also explains the recent growth in technical reserves to support a greater range of risks incorporated, even though the growth of system reserves has historically been consistent with the increase of industry premiums and business volumes (see as can be observed in charts 6 and 7. Fitch expects that this trend will not change in the medium and long term. The increase in pension reserves reflects the sales boom that began in 2000 and also the more reserve-intensive nature of a product that is still in the accumulation phase. This contrasts with the greater stability observed in the capitalisation segment, whose performance primarily reflects the pattern of redemptions and the issuance of capitalisation instruments.

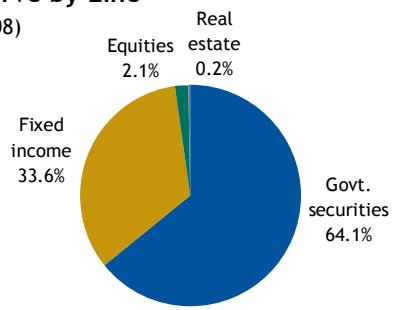
Another trend in the Brazilian system is the growing volume of contingencies, even though they still only represent a small portion of the insurance companies' liabilities. These are designed to meet tax and labour demands, as well as tax credits, and reflect, in part, the national companies' growing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

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

Asset Management

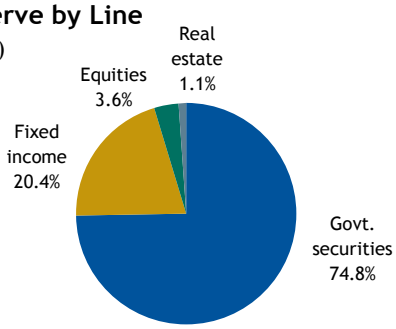
Sector assets which back technical reserves follow the general investment principles defined in the prudential rules and are monitored by Susep. In the case of pension entities, those plans blinding has not been effectively regulated. Consequently, the participants still helds low prirority in case of the insurance companies bankruptcy or extrajudicial liquidation. At the same time, Fitch notes that the sector follows very stringent standards for investment diversification, with most investment being allocated to fixed income assets, such as bank certificates of deposits (CDs) and federal government paper. A smaller proportion is applied in equities or multimarket funds, with a virtually immaterial share allocated to real estate (see Charts 8 and 9).

Chart 8: Assets Backing Technical Reserve by Line
(Jun 08)



Source: Susep

Chart 9: Assets Backing Technical Reserve by Line
(2003)



Source: Susep

Pricing of paper follows regulatory standards similar to those of the banking industry, with segregation of securities by type of trading and marking to market. For securities held to maturity, registration of the paper is generally tied to the financial capacity and intention of the insurer to maintain them in the portfolio, being booked at cost plus income earned, reducing the potential impact during periods of market volatility.

Risk control systems have been progressively perfected, which gives Fitch somewhat more comfort. In addition, most of the industry comprises insurance companies affiliated with financial institutions, which have more experience and focus on the management of investment portfolios.

- The leveraging profile is expected to change in the long term following the further business development and new prudential rules.

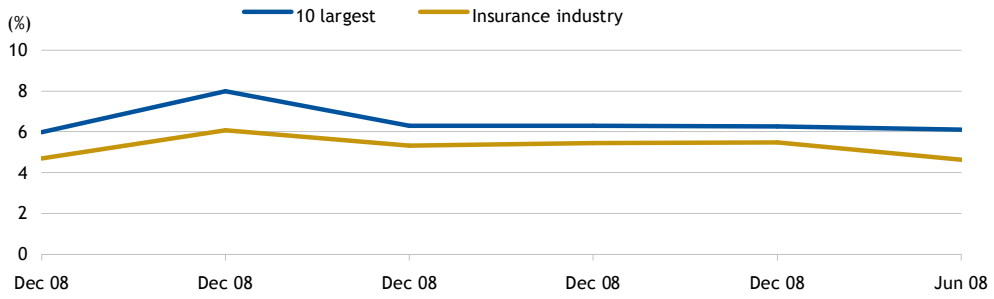
Capital and Leveraging

Although the sector's capital base has grown significantly, there has been an increase in operational leverage during the same period, mainly provoked by the increase in business (see Table 9). The sector's equity grew at an average rate of 15% pa between 2003 and H108, with the degree of leveraging, as measured by the liabilities/equity ratio, running around 5x to 6x. This, in part, is explained by the larger volume of reserve intensive insurance lines.

The regulatory changes are expected to strengthen the sector's capital base, one of the critical factors in light of growing competition and the evolution of capital and solvency limits. In Brazil, the solvency margin continues to reflect the volume of premiums issued and loss experience, ignoring the quality of the risks underwritten and other risks associated with the sector's activities. These risks are expected to be incorporated within the Solvency II regulations. The new capital rules adopted at the beginning of 2008 require a higher minimum capital. The required amount incorporates a fixed capital base of BRL15m (BRL7.2m prior to the new rules), plus a variable portion based on actuarial premises that consider the underwriting risks. The regulator has stipulated a period of four years for gradual adoption of the new capital levels and will monitor deficient institutions through solvency plans. These contemplate the institutions' business plans, as well as the projections and

measures that insurance companies intend to implement to reach the minimum capital required. Fitch considers as positive the initial measures implemented by the regulator regarding the capital adequacy of the insurers vis-à-vis underwriting risks, but expects that it will determine the incorporation of other relevant risks, such as credit, operational and market risks, in the capital base of the institutions. The agency also expects greater consolidation of the sector and of the smaller sized participants, whose business niches will not be so profitable within this new regulatory environment. It also foresees more Susep interaction with insurers to stimulate the adoption of controls that more efficiently reduce their risks by offering a greater benefit in terms of capital requirements to those that demonstrate improved risk mitigators and controls.

Chart 10: Liabilities/Equity



Source: Fitch