Reinsurance News

July 2011 – Issue 70

Brazilian Reinsurance Market Update

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In 1939, the Brazilian Reinsurance market was closed to direct access by international reinsurers. It was reopened in January 2010 and is now home to 84 multinational reinsurers and the State Reinsurer, Instituto Resseguradora do Brasil (IRB Re).

Even after two and a half years, the IRB still has the dominant market share. This article will discuss the major issues that the multinational reinsurers face in Brazil.

In 2009, the total reinsurance market was US$2 billion. This can be compared with a total 'insurance' market of US$23 billion for all lines of business (excluding health care). However the estimated reinsurance premiums for just three pipeline P&C projects are alone projected to be more than US$2.5 billion. These include the World Cup 2014, US$29 million; the 2016 Olympics US$324 million; and the Growth Acceleration Programme or PAC2, R$2 billion.

SO WHY IS EVERYONE FLOCKING TO BRAZIL?

- Brazil is a mature market and writes all lines of business, that being said …
- There is a lot of growth potential: world's 7th largest economy, but only the 17th largest in terms of insurance with only 3.3 percent of premium as a percentage of GDP (USA is almost 9 percent);
- Fairly segmented lines of business: Independents, Bancassurers, monoliners and multiliners, regional players, mix of multinationals and locals;
- No natural catastrophes (yet?);
- Because the market was closed for 71 years, there is a lot of potential to innovate and introduce the concept of reinsurance as a financial engineering tool;
- The guy to beat is still the state reinsurer. Taking market share from an inefficient and bureaucratic organization should not be mission impossible;
- Potential to earn very high rates of investment return. Short-term risk-free rates are 12 percent with inflation projected to be 6.5 percent this year; and
- Out of the BRIC countries (Brazil, Russia, India, China), Brazil holds the best record for free and fair democratic elections, economic stability, a government that is respectful of company law/shareholder rights and human rights.

Reasons why multinationals find the Brazilian market so challenging are as follows:

Firstly, Brazil is not really an open market. It is kind of like a three-ring circus. Reinsurers may apply for classification as local, admitted or occasional reinsurers. Currently there are eight locals, 23 admitted and 54 eventuals. The admitted and occasional reinsurers are at a distinct disadvantage since they do not have full access to reinsurance risks. However, the local reinsurers have the same rights and privileges as the IRB, but they need to deposit US$35 million of capital locally, can only retrocede 20 percent of their portfolio with their head offices and they need to submit to being regulated by the Brazilian Insurance Regulator (SUSEP); this means that one has to have a fairly large back office which drives up administration expenses.

Secondly, the Brazilian government keeps changing its mind regarding the regulation of reinsurers. In 2010, a hefty new "fiscal" tax was applied to local reinsurers. In March 2011, the rules were changed to reduce from 50 percent down to 20 percent, the percentage of a reinsurer's portfolio that can be retroceded to the locally based reinsurers' head offices, and now at least 40 percent of every risk must be reinsured locally. In April 2011, the government's 35 percent share of the IRB has been transferred to the Banco do Brasil, the state's largest bank. This year's recent changes have been interpreted as being designed to make the IRB even more difficult to compete against.

Thirdly, Brazilian underwriting standards and scarcity of claims data; which are acceptable to the IRB but are

well below international standards, which makes risk assessment/pricing extremely difficult.

Last but not least, Brazil can be a very expensive place to do business. Sao Paulo and Rio de Janeiro office rentals are amongst the world's top 10 most expensive cities. Sao Paulo salaries for the best and brightest (attracted to the financial sector) are on average, higher than in either New York or London.

The following points set out some proposals that address these and other issues:

1) Investment market. Brazil is really the place to be seen at the moment, from the front cover of *The Economist* to the front page of JP Morgan's in-house magazine, it's all about Brazil. Reinsurance CFOs should embrace the possibility of diversifying their investment portfolio to include Brazilian exposure and ratcheting up their overall portfolio yield. An analysis of the P&Ls of the local reinsurance companies show that the return on investments are very low; much lower than short-term risk-free rates which are now around 12 percent. Pricing actuaries need to think opportunity and not cost of capital and competitive pricing means including investment returns. Of course, focusing on maximizing asset returns will require local reinsurance companies to start to recruit local experienced investment professionals.

2) Government regulation. One can accuse the Brazilian government of many things, but these do not include acting fast or working secretly. So why have reinsurers been blind-sided with overnight changes that have fundamentally affected their business models? Currently there is a disconnect between the local reinsurers and the corridors of power in Brasilia, the nation's capital, that can be rectified by recruiting specialist lobbying firms. Whilst this may not be the modus operandi for foreign reinsurers, it is common for cedant companies to do so, and reinsurers should consider following their clients' lead. The objective here is to gain access to information and manage expectations of the reinsurers' head office regarding changes in the regulatory landscape on a timely basis.

3) Access to proper claims data. The majority of cedants will provide claims data that are below the minimum standards set by reinsurers' underwriting guidelines. Fact! The IRB will offer competitive quotes based on very poor data. Fact! Now the unappreciated actuary will come to the

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rescue. In Brazil there is only one FCAS and two FSAs, and only one is with an actuarial consultancy. The majority of actuarial consultants don't provide local support regarding detailed claim analysis and the few that do, charge a fortune and don't have actuarial models that are adapted to the Brazilian environment. Reinsurers' have a golden opportunity to offer actuarial services in exchange for detailed claims analysis, e.g., services such as pricing analysis (providing an objective view of what the costs of the portfolio are and some insight into frequency and severity trends); ALM; introducing ERM; developing economic capital models; and testing for dynamic solvency, etc. It is not realistic to expect a cedant's IT department to swing into action to prepare comprehensive claims data just for a reinsurance quotation. Quid pro quo is a better strategy for extracting the required data. For life and health clients (where the risk is more deterministic than stochastic), a simple approach would be to undertake market segmentation (e.g., who are your bancassurance clients) and then use mosaic theory to piece together an amalgam of claims information from several clients to form a complete picture of your target market.

4) Underwriting procedures that are below the level required by the reinsurer's corporate guidelines. This is probably the hardest sell to the head office—how to convince your CRO to do business with a client that's not aligned with documented (or non-documented) underwriting philosophy. The main issue is how do you classify the cedant? Are they looking for market share or are they profit-oriented? (they will all say that they are profit-oriented). For the targeted cedants, you need to get as close as possible to the technical director via training programs, working together on some of those actuarial projects mentioned above and presenting him/her to your chief actuary at the head office (the guy/gal who can make underwriting exceptions). In Brazil, I would argue that underwriting the underwriter is far more important than what is documented.

5) Understanding pricing models/product development. The life market has US$3.5 billion of risk premium and R$117 million of life reinsurance premium. This is split 60 percent with the IRB and 40 percent all others. The health market has US$29 billion of premium and US$700,000 of health reinsurance premium (yes really! there's only one health cat contract with a Lloyds syndicate). This disconnect between cedants and reinsurers exists since there is a world of difference of opinions regarding reinsurers/cedants pricing margins. Pricing margins for cedant companies' life and health portfolios are 10 percent and 5 percent respectively. Reinsurers should consider offering services such as pricing models/product development. Only by working with cedants on such projects will the reinsurers's technical staff start to feel more comfortable with following the fortunes of the local market. Another completely unexplored area is for the reinsurer to consider working with major corporate/retail insurance brokers to develop products that are exclusive to them—coinsuring the risk between the broker's client (the cedant) and the reinsurer.

6) Going native. No article in an SOA Reinsurance publication would be complete without a comment on the standard life reinsurance product that presently exists. One of the first things that visiting reinsurers notice about the standard life reinsurance contract is that it's odd. And yes it definitely is! Years and years of not working with the international market has led to the development of a local product that's more tailored to ease of operations rather than risk management. The standard product offers the reinsurer a lot of short-term volatility in return for very small margins. The contract is based on group life business; a one-year product (YRT), with retentions that are generally based on per life and not per coverage and vary depending on the size of the company between US$60,000 and US$600,000. Capacity is also generally limited per life and not by coverage. There's generous profit sharing; no annual aggregate claims limit for the

portfolio; no right to the run-off and pricing refers to attained age based on AT83 mortality rates, which is neither what cedants price on, or reflective of the shape of Brazilian life mortality. Both individual life facultative services (in Portuguese) and complementary catastrophic treaties must also be offered to win treaties. Historically the life reinsurance market has not been profitable for the international life reinsurers due to the four specific major plane tragedies (two with TAM, one with GOL and one with Air France). Nevertheless in order to gain a foothold in the Brazilian market one needs to undertake market segmentation; carefully select target clients and initially follow the standard life reinsurance contracts.

CONCLUSION

In summary, the main difficulty for multinational reinsurers is that there is a distinct lack of strategic alliance between the ceding companies and the foreign reinsurers. The reinsurers are cherry picking their risks and the cedants don't feel as if they have a risk partner that they can count on for good and bad times. It is all very opportunistic at the moment.

On balance the opportunities greatly outweigh the challenges. Brazilian business culture is not steeped in tradition; quite the opposite. It is vibrant and dynamic and it is always possible to reinvent your strategy and represent a new face to the market. With the right team in place and a strategy that's aligned to major cedants, market leadership is there for the taking!

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