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# Brazil Update

by Ronald Poon-Affat

*Editor's Note: The opinions expressed in this article are personal and do not necessarily reflect those of the author's employer.*

Brazil is considered to be one of the major economic powerhouses within the emerging markets. Its economy is compared with Russia, India and China; together these four make up the BRIC countries. Brazil is presently the 11th largest economy in the world and is expected to be again listed within the top 10 during the next two years.

## Facts and Figures

The first box (below) shows the main financial indicators relating to the exchange rate, stock market indices, trade surplus and risk classification. The second box shows up-to-date GDP and population figures. The first graph shows the monthly development in the main stock index (over 20 percent this year and presently at its all-time high). The second graph shows the development of the short-term interest rates (annualized) … and yes, they are that high! The present rate is 18 percent per annum, but the general outlook is that rates will decline to 16.1 percent, 14.7 percent and 13.7 percent at the end of 2006, 2007 and 2008 respectively. Inflation is expected to run at around 5 percent, thus providing very high real rates.

| Indicators | Nov-05 | 2004 YE |
|---|---|---|
| Exchange Rate | R$ 2.21 | R$ 2.65 |
| Ibovespa (Index) | 31.916 | 26.196 |
| IBX | 10.195 | 7.796 |
| Trade Surplus (Million) | US$ 40.440 | US$ 33.664 |
| Brazil Rating (Moody's) | Ba3 | B1 |
| Brazil Risk (J.P. Morgan) | 342 | 382 |

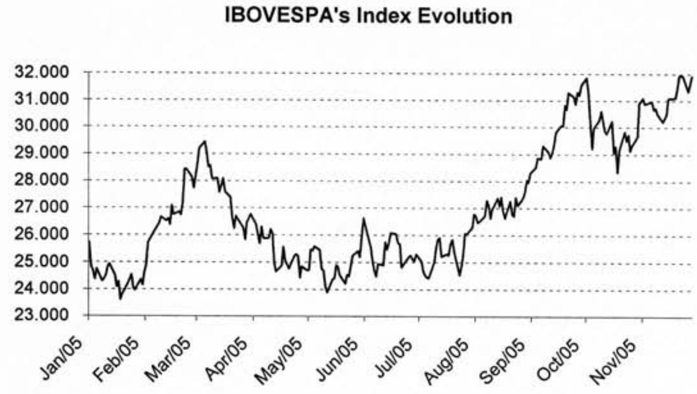
| BRAZIL'S PROFILE | |
|---|---|
| GDP (purchasing power parity) | US$ 1,492 trillion |
| GDP per capita (purchasing power parity) | US$ 8,100 |
| GDP growth rate | 5.1% |
| Population | 186.1 million |

## Major Events

Let us first start off with the major event that never happened, the opening of the Brazilian reinsurance market. Brazil is in the company of countries like Cuba, North Korea, Iraq and Iran when one considers which countries still have a monopoly on reinsurance. The promise of the market opening (always within the next two years) reached a high point around 1995, but it never was realized. Even though the ruling party at the time (PSDB whose leader was Fernando Henrique Cardoso) very much wanted this to happen, the opposition (PT, the Workers Party, which is now in power) was always able to successfully block the opening. Of course when PT assumed power in 2002, the opening was not at the top of their agenda. Brazil is presently in the midst of a torrid political scandal that includes serious allegations of corruption. This scandal includes the local reinsurance company (IRB) and this may be the most significant event that may force the opening of the market. My best guess (and this is a very personal view) is that this opening depends on who wins the presidential elections in October 2006. If PT wins the election, then they will continue with their plan of opening the market and it may open as early as 2007. If PT loses (and political scientists expect that PT will lose), then the new government will need to appoint a new team to be responsible for the opening and this could be delayed until 2008. In any event, whomever wins, there is now the political will of both major parties for opening the reinsurance market. It's not a matter of if, but when, the reinsurance market will open.

## Exit of Many Players

In spite of globalization and the fact that Brazil is definitely embracing all that the world has to offer, as far as insurance goes Brazil is quite unique as many foreign companies have discovered. Over the last 24 months, we have seen a significant reduction of many multinational's insurance portfolios. The major insurance transactions include:





| | |
|---|---|
| ABN Amro | Sold life, pensions and P&C company (Real Seguros) to Tokyo Marine. Exited Brazil. |
| AGF/Allianz | Sold life and pensions portfolio to local company, Itau. Still writes P&C and health. |
| AXA | Sold life and P&C company to local company, Porto Seguros. Exited Brazil. |
| BBV | Sold life and pensions portfolio to local company, Bradesco. Exited Brazil. |
| Canada Life | Sold life and pensions portfolio to Icatu-Hartford (author's company). Exited Brazil. |
| CIGNA | Sold life and pensions portfolio to AIG/Unibanco and their health portfolio to a local company (AMIL). Exited Brazil. |
| CitiInsurance | Sold portfolio to MetLife (worldwide deal with the exception of Mexico) |
| Combined Insurance | Exited Brazil. |
| Generali | Sold health portfolio to HSBC. Still writes life and P&C. |
| HSBC | Sold health portfolio to Sul America/ING. Sold its motor portfolio to Hannover. |
| Nationwide | Sold pensions portfolio to Icatu-Hartford, life portfolio had a management buy out. Exited Brazil. |
| Zurich | Sold life and pensions portfolio to MetLife. Still writing P&C. |

It has also been reported in an influential magazine (*Veja*) that ING will be selling its interests in Sul America to a private equity group. However the respective groups are not commenting further on this transaction.

While each of these exits will have their own particular reasons (negative profitability, difficulty in establishing distribution channels, unpredictable regulation especially in the case of health, closed reinsurance market, lack of underwriting professionalism within the market, transfer of resources to China and India), it does show a worrying trend. In addition to which, until four years ago there were around 16 reinsurers which had representative offices (author used to represent Gen Re Life & Health). Now there are only five.

Brazil is still dominated by very few Insurance companies. The four major players, Bradesco, Sul America, Porto Seguros and Itau account for 51 percent of the market share. Another way of looking at Brazil is the distribution of insurance between those companies that have a banking distribution channel (62 percent) and those that don't, the independent companies (38 percent).

## Change in Pensions Legislation

During 2005, legislation was changed to make investing in private pensions one of the most attractive investment options. A tax benefit always existed that made up to 12 percent of clients' annual taxable revenues, which was eligible for tax credits when applied to a personal private pension fund.

The change that was made was that clients can now choose under which tax regime they would like to be classified in the event that they choose to withdraw funds before vesting. The first (and new option) allows clients to pay a declining tax penalty that starts off at 35 percent in the first year and then gradually declines to 10 percent after 10 years. Please bear in mind that the highest tax rate applied to income is 27.5 percent.

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| Tax liability declining rate | Years after inception |
|---|---|
| 35 percent | First two years |
| 30 percent | 2 - 4 |
| 25 percent | 4 - 6 |
| 20 percent | 6 - 8 |
| 15 percent | 8 - 10 |
| 10 percent | > 10 |

By choosing the "declining tax table under the 1st option" clients are allowed to pay income tax under a declining tax rate schedule. Therefore for long-term investors, they can get an initial tax credit of 27.5 percent and then pay a tax penalty of only 10 percent after 10 years. For a short-term investor, this first option is not attractive since if withdrawal is made in the first four years, the tax penalty would exceed the initial tax credit (27.5 percent). The second tax option that is referred to as the "progressive tax table" was always in place: it basically reverses the tax credit upon withdrawal, i.e., if you received a tax credit of 27.5 percent (highest tax bracket) then you would be penalized for this exact tax credit upon early withdrawal before vesting.

## Other Legislative Changes

There were two major changes that affected the life market. First, the elimination of the 'any occupation' disability rider. The regulators have suggested that the market should consider offering replacements of either an 'own occupation' disability (which I think is a really bad idea) or a benefit that is payable contingent upon the certain loss of Activities of Daily Living functions. Many players are either thinking about completely canceling all disability riders or offering a Critical Illness type of policy.

The second change was the elimination of flat unit-rate premium structures for group life schemes. Now companies will have to offer premium rates that are in increasing five-year age bands. These two changes demonstrate how the Brazilian regulators are prone to decide what's best for the market rather than letting brokers/consumers decide for themselves.

## Listing on the Ibovespa

Porto Seguros is the only insurance company to get listed on the local stock market. It now has 28 percent of its shares on the stock market. It listed on November 2004 at R$18.75 and as of Dec. 8, 2005, it was quoted at R$25: a 33 percent increase. It should be noted that the Ibovespa increased 35 percent during this same period. Even though the Ibovespa is at its historical high, when comparing price to book value, the *Economist* magazine confirms that Brazil is still the cheapest stock market amongst the major emerging markets. Porto Seguros has a market cap of US$854 million, a PE of 9.98 and an ROE of 17.43 percent. It enjoys coverage from five major analysts, including Bradesco, CSFB, Pactual, Safra and UBS. Porto Seguros' portfolio consists of 63 percent auto, 16 percent health and 6 percent life.

## Opportunities in Brazil

The main opportunities include products that allow companies to earn significant interest spread (capitalization business and defined benefit pensions products) or those products that can be sold on a mass-marketing basis in large volumes: this will almost always imply a strategic alliance with a bank or an institution that has developed a private-label affinity card for its clientele.

Health insurance is very problematic, but there are companies who are only selling group health products and they are making money. The sale of individual health products is very complicated, since terms and conditions and price increases are strictly controlled by government agencies.

The Private Individual Pension market (PGBL, VGBL) is a very attractive niche (no guarantees to the client), but please bear in mind that it provides about a 1 percent margin to cover fixed expenses so one needs to get up to at least R$1.5 billion in reserves to start making money. More so, the expenses and effort associated with getting to R$1.5 billion of PGBL reserves should not be underestimated. □

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