Article from

**International News**

May 2018

Issue 74

# Latin American Insurance Regulatory Update

By Carlos Arocha

Gross written insurance premium in Latin America is about $150 billion,[1] about a tenth of the corresponding annual insurance production in the United States and Canada taken together. Notwithstanding, premiums in the region have been growing steadily over the past few years, as the local economies develop and modernization in industry, technology and societal changes spur the growth of the insurance sector.

Penetration is relatively low: at 3.2 percent of GDP, the subcontinent lies well behind the emerging Asian markets, let alone other more developed insurance markets. The same is true for the premium density metric, or the amount of premium dollars per person. Latin Americans spent less than $260 per year in insurance, compared to about $2,300 spent in the United States.[2]

Latin America is a group of 20 countries[3] with a combined population of 640 million, two major languages, and an area of more than 7.4 million square miles. A direct flight from Mexico City to Buenos Aires takes about 10 hours.

Two large commercial trade blocs are in place: *Mercosur*, grouping Argentina, Brazil, Paraguay, Uruguay, and Venezuela (although admittedly, the bloc's economic engine is fueled by Argentina and Brazil only), and *Alianza del Pacífico*, that includes Colombia, Chile, Mexico, and Peru.

Whilst Brazil's budget balance is close to –7 percent of GDP,[4] policymakers in Mexico, Chile, and Colombia implemented monetary and fiscal policies that have improved the state of their economies. But the renegotiation of the North American Free Trade Agreement (NAFTA) looms large over the Mexican economy.

## DRIVERS OF INSURANCE GROWTH

Barring Venezuela and Cuba, Latin America is becoming more politically stable as democracy is taking a hold. The growth of the regional insurance industry is driven by the following:

1. More awareness and knowledge about natural disasters—the renewed interest in issuing catastrophic bonds (a form of insurance-linked securities) by the World Bank and the governments of Mexico, Peru, Colombia, Chile and Argentina, illustrates the use of international finance and global reinsurance markets to model natural catastrophes. In turn, specialists from a few countries have developed expert systems to measure risk.
2. A growing middle class—there is more demand for savings products, particularly, to finance children's education.
3. Compulsory insurance—in many countries, automobile third-party liability, workers' compensation and other forms of liability insurance are compulsory.
4. Bancassurance—the use of the banking infrastructure to reach the unattended population, has motivated the establishment of micro insurers. Anyone who has visited El Alto, in the outskirts of La Paz, Bolivia, can attest that micro finance has helped millions of small, family-owned businesses.
5. Mass marketing—thanks to new distribution channels, insurance companies are reaching new market segments and new generations, including the techniques of InsurTech. Technology is probably one of the most important drivers of insurance growth in the region.
6. Growth of commercial insurance—as economies flourish, small and medium companies are being established. These companies have appetite for credit insurance, commercial property damage, third-party liability, and other forms of insurance.

## INSURANCE PROTECTION GAP

Notwithstanding the fact that insurance is developing rapidly in Latin America, there is a huge protection gap. It is difficult to produce a meaningful measure of how much markets could grow, but if the insurance density and penetration of the more advanced markets is taken as a proxy, one can probably reach the conclusion that the industry is less than one-third developed. Stated differently, if the current premium production is about $150 billion, the market would have potential today, to be worth some $450 billion at constant prices, maybe more.

## GROWTH POTENTIAL

Latin America has one of the lowest insurance penetrations in the world. But its 640 million people, the fact that Spanish is the dominant language (as is Portuguese for the 209 million Brazilians), and a relatively homogeneous culture, makes it somehow easy to devise regional marketing strategies and expand into new products and services.

The economic and political stability invites foreign investors to the region. Mexico, one of the region's top economic engines, has witnessed a 15-year period of macroeconomic stability previously unseen. The evolution towards global regulatory and financial systems and the alternative distribution channels being explored, add to the list of arguments behind the region's growing potential.

## ASSAL and IAIS

Both the Latin American Association of Insurance Supervisors (ASSAL) and the International Association of Insurance Supervisors (IAIS) have made a host of commitments to modernize insurance regulation, ranging from developing a balance sheet approach to solvency, to the establishment of disclosure and transparency measures that are more aligned with international standards, such as the European Union's Solvency II Directive. ASSAL works through committees for education, microinsurance, solvency, and information exchange.

The IAIS has proposed a revision of its Insurance Core Principle No. 1, to suggest that primary insurance legislation must define its objectives: the protection of policyholders, the maintenance of a fair, safe and stable insurance market; and the contribution to financial stability. These measures have been enthusiastically adopted (or at least seriously considered) by most Latin American insurance regulators.

## STAGE OF DEVELOPMENT OF RISK-BASED REGULATION

Solvency II, the Swiss Solvency Test, and other regulatory solvency capital directives, have been catalysts for risk-based solvency regulation throughout the world. For many years, solvency capital was calculated as a function of premiums or claims for general insurance, or of reserves and nets amount at risk for life insurance.

These methodologies were practical but did not address the inherent risk characteristics of insurance portfolios, nor credit, market, and operational risks. The European paradigms meant an overhaul of regulatory capital rules, and regulators in most countries in Latin America have initiated projects to shift to a risk-based capital regime. Countries can be classified in groups:

| | |
|---|---|
| SOLVENCY MODERNIZATION IS WELL UNDERWAY OR HAS ALREADY BEEN ENACTED INTO LAW | • Brazil<br>• Chile<br>• Mexico |
| SOLVENCY MODERNIZATION PROCESS HAS BEEN INITIATED | • Colombia<br>• Costa Rica<br>• Peru |
| LITTLE OR NO ACTIVITY REGARDING SOLVENCY MODERNIZATION | • Rest of Latin American countries |

We now turn to the stage of solvency modernization in selected Latin American countries and the insurance supervisory agency in charge of solvency modernization projects.

### Brazil

***SUPERINTENDENCIA DE SEGUROS PRIVADOS (SUSEP)***

- New regime has been gradually introduced
- The insurance risk module is factor-based
- There is a capital requirement to mitigate credit and operational risk
- Market risk requirements have been gradually introduced
- Supervision activities have been strengthened, and aimed to be consistent with the Solvency II Directive
- SUSEP may be understaffed

### Chile

***SUPERINTENDENCIA DE SEGUROS Y VALORES (SVS)***

- Solvency modernization project launched in 2004
- Approach analogous to Solvency II
- Mandatory quantitative Impact Study No. 5 issued in May 2017
- Quantitative requirements have been approved by congress, but qualitative and supervisory requirements require no approval
- A 6th Quantitative Impact Study is being planned in 2018
- It is foreseen that insurers will have to appoint a chief risk officer

Solvency II and the Swiss Solvency Test have been catalysts for a risk-based solvency regulation throughout the world.

### Mexico

***COMISIÓN NACIONAL DE SEGUROS Y FIANZAS (CNSF)***

- Solvency modernization project launched in 2014
- A mix between Solvency II, Switzerland's Swiss Solvency Test, NAIC methodologies, and organic development
- Qualitative requirements in place as of April 2015, including solvency and financial condition reports and quantitative requirements in place as of January 2016
- Compulsory dynamic solvency requirement and stress tests
- Shift to an economic balance sheet for compliance reporting, which together with the new solvency requirements, has increased financial statements volatility, particularly for life insurers

### Colombia

***SUPERINTENDENCIA FINANCIERA DE COLOMBIA (SFC)***

- Gradually shifting from a factor-based model to a risk-based model
- Underwriting risk is measured by a Solvency I-type formula (i.e., a factor-based model)
- Credit and market risk capital charges already in place
- Companies may use an internal model upon approval by the SFC
- Circular 045 requires an independent appointed actuary to validate and certify reserves on a monthly basis

### Peru

***SUPERINTENDENCIA DE BANCA, SEGUROS Y AFP (SBS)***

- Solvency modernization project launched in 2008
- Solvency is factor-based with additional capital charges for credit, market and operational risk
- In 2014, the SBS implemented a capital charge for asset concentration risk
- Debt for insurance companies cannot exceed the total solvency capital
- The actuarial function (mimicking the Solvency II Directive) has been prescribed
- Reserving guidelines have been revised
- There is a pathway to establish quantitative impact studies

## HOW TO MODERNIZE SOLVENCY CAPITAL REQUIREMENTS

Through international cooperation, the Insurance Core Principles of the International Association of Insurance Supervisors have set the tone for industry regulation in much of Latin America. There is, however, an enormous gulf between highly developed economies and emerging markets, that is being addressed by regulators, industry leaders, and other stakeholders.

Insurance regulators face substantial challenges, and there is probably no one-size-fits-all solution to the problem of requiring companies to determine an appropriate solvency capital requirement. Many jurisdictions worldwide have attempted established simple rules and methodologies that represent a fair solution for the industry, and avoid unintended consequences, such as business mix changes to optimize regulatory capital utilization.

Latin America may be relatively homogenous, but each market is different—each market should engage in modernization projects at their own pace. A full-blown risk-based solvency regime may not be the answer to solvency modernization—viable alternatives such as simplified factor models, scenario models, and stress tests warrant consideration. ■

Carlos Arocha, FSA, is managing director of Arocha & Associates, an actuarial consulting firm based in Zurich, Switzerland. He can be reached at *ca@ArochaAndAssociates.ch*.

**ENDNOTES**

1 Sigma 3/2017, Swiss Re Institute

2 Ibid.

3 Not counting the Anglophone, Francophone, and Dutch-speaking countries such as Belize, Guyana, Surinam, and Jamaica.

4 The World in 2018: The Economist Intelligence Unit