

# Focus on Brazil

For more than a decade a succession of Brazilian governments has promised to liberalise the country's reinsurance industry. Now it is really happening, but how great will the impact be? **By Jonathan Wheatley**

**T**he monopoly held by the Instituto de Resseguros do Brasil (IRB) is being removed and from 15 April 2008 the reinsurance market will be thrown open to global competition.

The pace of change will be cautious and nobody is expecting a revolution overnight. Some habits will take time to be shaken off. But Brazil's market will never be quite the same again. Business can only expand, and many of the world's biggest players are lining up to take a share.

## Long-awaited change

"We are very excited about the opening up of the market," says Mark Drummond Brady, International Chairman of Jardine Lloyd Thompson. "It provides significant opportunities for the whole of the insurance industry and, most importantly, for the buyers, because although the process will be gradual it does open the possibility of the insurance industry being able to acquire reinsurance directly from the commercial market, which clearly will create an element of competition that is not there today."

The IRB will give up its monopoly only slowly and partially (see box right). As

## WHAT WILL CHANGE?

### Before

IRB operates as reinsurance regulator and monopoly supplier of reinsurance in those markets where it operates. All reinsurance business is offered to the IRB; it is free to take what it wants and pass anything else to international markets as retrocession.

### After

For three years from 15 April 2008 the IRB will retain right of first refusal on 60 per cent of all reinsurance business. Thereafter it will retain that right over 40 per cent of all business. No date has been set for this reserve to be reduced further.

Three types of reinsurers will be allowed to operate in Brazil:

- 'Local' reinsurers will create Brazilian companies with capital of at least R\$70 million.
- 'Admitted' reinsurers will have to have a local office and hold at least US\$5 million in a current account in Brazil.
- 'Occasional' reinsurers will have only a representative office in the country.

Drummond Brady points out, this may be no bad thing: "The 60 per cent rule is a sensible move," he says. "They don't want a revolution. The IRB has been the regulator as well as the monopoly reinsurer, so apart from the jobs involved there's a huge government stake in continued stability. In a country like Brazil deregulation is better handled gradually than by letting everything fall to market forces."

In fact the IRB has already moved some way away from its former reputation for stultifying bureaucracy and worse – largely the result of the appointment of a highly respected central bank technocrat, Marcos Lisboa, who as its President until March 2007 saw it through much of the preparation for deregulation.

"The IRB is very serious nowadays," says Nicolau Daudt, CEO of JLT Re in Rio de Janeiro. Nevertheless, he says, the IRB can no longer be all things to all the market. "New products, new solutions, different kinds of reinsurance stay on the shelf as there is no time for the IRB to do that," he says. "So there will be a lot more creativity and a lot more dynamism in the market."

The sums involved are fairly modest. The IRB currently sends a bit more than US\$500

FIG.1: IRB TOTAL PREMIUM AND RETROCESSION

	R\$ millions		
	2005	2006	2007
Total premium	2,574.7	2,634.0	2,734.2
Premium retained	1,394.7	1,323.0	1,445.2
Retrocession	1,180.0	1,311.0	1,289.0

*Source: IRB*



million a year in premiums to reinsurers outside Brazil. "The idea is that from the first to the second years [after deregulation] the total reinsurance premium will rise from US\$1–2 billion, of which 60 per cent will stay in Brazil," says Daudt.

Perhaps for that reason, says Drummond Brady, "not everybody is focused on Brazil as a major opportunity." Indeed, going on past experience of deregulation in other markets, some players may be expecting very little to happen. The Big Bang on London's financial markets turned out not to be very big. Ten years after deregulation of Japan's insurance market, market shares, Drummond Brady says, "haven't changed one jot".

But Brazil is not Japan. "If it was," says Drummond Brady, "I wouldn't be recommending to my colleagues that they gear up for the opportunity."

### Positive fundamentals

There may be no shortage of sceptics who have lived through too many unfulfilled promises of change in Brazil to expect progress to be anything but slow. But just as the IRB has been gearing up for change, more fundamental changes have been

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taking place in Brazil. For the 20 years up until about 2003, the economy loped along at an average growth rate of about 2.5 per cent – laggardly by any measure and far short of the kind of growth seen in Russia, India and China, Brazil's fellow members of the BRIC club of emerging market champions.

During that period, growth occasionally peaked at about 5 per cent before dropping back into another trough. But for the past few years, the economy has been expanding steadily at annual rates of between 4–5 per cent. That would still leave Brazil's peers

feeling pretty unimpressed, but for Brazilians it has made a world of difference.

At first, growth was driven by the export sector. Brazil is the world's largest exporter of sugar, coffee, orange juice, soya, beef, tobacco, chicken and iron ore. It has a large and growing automotive industry; Embraer is the third biggest aircraft maker in the world (and the biggest maker of regional jets); its industrial base is mature and diversified. Global demand led by China and India caused an export boom over the past few years which produced huge earnings for large sectors of the economy.

As the threat of recession in the United States and a broader slowing of the global economy has slowed the rate of exports (though they remain strong), Brazil's domestic economy has begun taking up the slack.

Employment has been rising steadily, so have wages. Income transfer programmes and new forms of credit – particularly with repayments deducted from pay packets or pensions payments – have brought millions of people within reach of consumer goods that they could previously only dream of.

The rate of investment has risen strongly. Last year, Brazil attracted an



Rio de Janeiro



»»» extraordinary US\$34 billion in foreign direct investment, helping to push the overall rate of investment up towards 20 per cent of gross domestic product (GDP) – still not great by many standards, but much better than Brazil’s recent past.

This all means that there are good reasons to be interested in Brazil, especially as its insurance market begins to open up to new ways of doing things. It does not mean the market will explode. But a look at the way today’s market is structured provides some pointers to where growth will be concentrated in the coming years.

### Positive insurance outlook

As Tom Goman, President of JLT Brazil points out, about three-quarters of premiums in the country are generated by auto, life and health policies. “That means that about 25 per cent of the market is non-life – property, engineering and so on, the part where Brazil needs to invest to grow.”

Opportunities, however, will come in both segments. In auto, life and health, scope for reinsurance is limited because insurers have the capital to underwrite risks themselves. In these areas, with or without deregulation, the trend is for more sophisticated products to be developed by local suppliers. This is already happening. High-quality pensions products, for

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example, have been developed by local banks as the population has come to realise that pensions provided by the state system will fall far short of their retirement needs.

Reinsurance will play a part in offering alternatives, for example, to health insurance in the form of self-administered health plans where corporations pay for the services that their employees receive from health service providers. “That’s what the opening of the market is going to offer,” Goman says, “and if reinsurers get valid information they will underwrite it.”

But Goman is most interested by developments in the other quarter of the market. “Our opportunities will come from infrastructure investment,” he says, “in products like engineering insurance, surety

for international investors to guarantee that projects will complete and perform according to their contracts, and in areas such as protecting international investors from professional errors and omissions.”

### Cautious optimism

Despite the range of new opportunities opening up, everyone *Risk Specialist* spoke to about the changes taking place in Brazil seasoned their optimism with a good helping of caution. “Any new competition is always healthy,” says Isabel Braga, a risk manager at Queiroz Galvão Oil and Gas in Rio de Janeiro, “because it makes for more agile and transparent processes, as well as lower premiums of course. But here at QGOG our expectations are not too great yet because our own processes are likely to remain largely unchanged until the market opens completely.”

The IRB, after all, is a very well-entrenched player with its own processes that will take a long time to change.

“We’re going to have a pretty complicated couple of years,” says Goman. “I think a number of, especially, international clients are going to find it all rather frustrating.”

One problem, he says, is that international reinsurers will still have to offer first refusal to the IRB, and that neither side will be used to the other’s methods. “International reinsurers will offer terms for a specified limited time, and the IRB will have to say yes or no. Saying nothing won’t be valid any more, but silence or a lack of urgency could take control. It will take them a while to get their ship in order.”

Many players, in fact, may find this state of affairs to their liking. “One thing about the IRB,” says Drummond Brady, “is that you may not get much variety in terms and conditions, but you do get a consistency in service that people have got used to over the decades. That doesn’t just change overnight.”

Nevertheless, he says change is inevitable in the medium term. “International reinsurers will go in very hard to try to change habits. They’ll look to change things through commercially priced, state of the art products, rather than through the IRB. They’ll meet a lot of resistance. But they’ll push hard.” **RS**

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# Brazil's risk rating

Compared to many of its emerging market peers, Brazil has a relatively benign risk profile. Democracy may be relatively new (the last military government stepped aside in the mid 1980s) but it is very well established. Public protests occur, but riots are less common. The risk of earthquake is negligible (there was a small one in a remote region last year with very few casualties). Tornadoes and hurricanes do not happen.

Crime, however, certainly does.

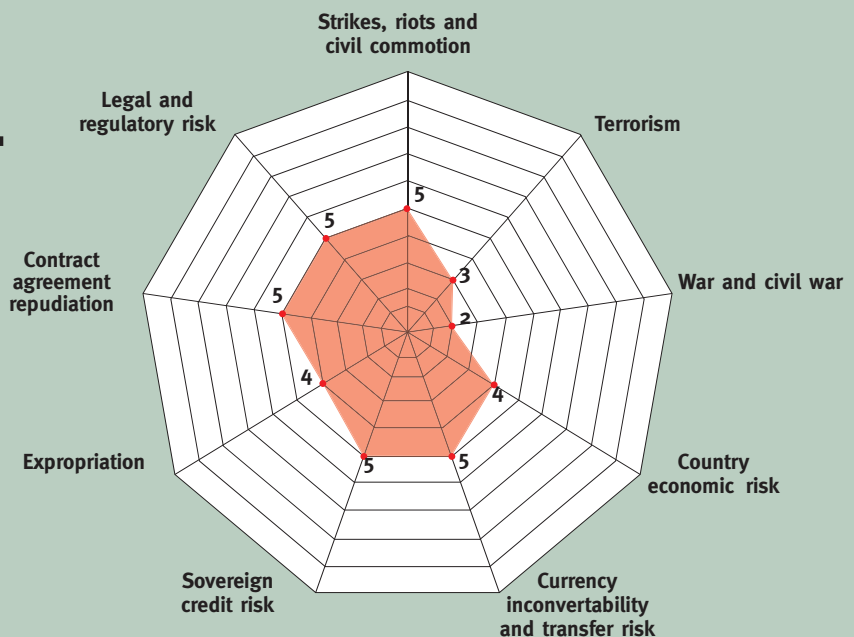
Muggings and other street crimes, such as so-called lightning kidnappings, are a constant concern. In some parts of the country – not only in large cities but also, increasingly, in remote regions where the state is all but absent – rates of homicide look more like those of a country at war than of one at peace.

For companies coming to do business in Brazil, such risks must be taken into account. So must regulatory and judicial risks: rules change frequently and often are not enforced, as judges have a freedom to interpret the law, which many from developed countries would find surprising.

And Brazil is still not free from its history of debt default and near-default – as recently as 2002, many investors fully expected Brazil to collapse into fiscal and monetary chaos.

On the macroeconomic side much has changed since then. Inflation is under control, interest rates have fallen and, since January, Brazil has actually been a net creditor with the rest of the world, with its US\$190 billion in foreign reserves comfortably outweighing both public- and private-sector foreign debt. But the memory of macroeconomic mismanagement is too fresh for such fears to have gone away altogether, says Elizabeth Stephens, Political Risk Analyst at Jardine Lloyd Thompson.

“Brazil is very heavily dependent on exports and susceptible to external shocks, and there is a big issue with the credit crunch at the moment,” she says. “If current trends continue Brazil could become investment-grade, but that depends on the global economic environment remaining favourable and that’s an unknown quantity.”



World Risk Review™ ratings for Brazil

Of particular concern, she says, is Brazil's fiscal structure. The government has been successful in maintaining big enough primary budget surpluses (before debt repayments) to keep the ratio of public debt to GDP on the way down. But it has done so by raising its tax take rather than cutting spending. There is a limit to how long it can repeat that trick, but little sign that it is willing to spend political capital to trim the bloated machinery of government.

Corruption, which is rarely out of the news, is another concern, especially in as much as it compromises the rule of law and contract enforcement. Stephens points to

other worries, such as recent controversy over the role of soya and sugarcane in pushing illegal ranching and logging deeper into the Amazon forest.

Overall, though, she says she should soon be ready to give Brazil an upgrade, especially on macroeconomic issues. “It’s a waiting game,” concludes Stephens, “to see if the president can keep the economic situation progressing positively. But our clients view Brazil quite favourably compared to some other countries in the region. It’s a relatively straightforward place to do business.”

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