

REINSURANCE – BRAZIL : A TENTATIVE STEP TOWARDS AN OPEN MARKET?

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The long awaited opening of the Brazilian reinsurance market is set to begin on 17 April 2008. The Brazilian regulators expect the open reinsurance market to double in size. In response, Lloyd's, Swiss Re and Munich Re, amongst others, have applied for authorisation to operate in Brazil in direct competition with the old state owned monopoly, the IRB (Brazilian Reinsurance Institute).

Commentators consider the reforms may permit greater competition from international reinsurers in the local market. However, there are many gaps and a significant lack of clarity in the reforms which could provide the basis for a revival of protectionism. At this unsettled moment, it is crucial that international reinsurers continue to engage in discussions with the Brazilian regulators. It is only by this exchange of views that it can be hoped that the positive changes in favour of open competition set out in the new regulations may be maintained and a viable and competitive local reinsurance market achieved.

Following the enactment of the new reinsurance law, Complementary Law Number 126 (the "CL") on 15 January 2007, regulations were issued by the Brazilian regulators on 19 December 2007 ("the regulations") in order to detail the new framework for the open market.

During both the consultation process and in the final drafting of the regulations, the local regulators have showed some hesitation in deciding on the final rules. This hesitation was probably due to the need to accommodate representations from competing interests of existing and new participants in the local market. Although expected to be issued within 6 months from the passing of the CL, the regulations took 11 months to be produced.

The ultimate result was the adoption of a liberal reading of the CL. As issued, the regulations depart substantially from the more protectionistic stance of the earlier drafts and from the more protectionistic purpose behind the CL. However, this favourable disposition towards an open market is by no means certain to be maintained. The many areas of uncertainty in the regulations are likely to give rise to further disputes between the traditional and new players in the market.

The main features of the open market

In sum, the reforms enacted by the CL provide that foreign reinsurers may apply to operate in Brazil as authorised reinsurers under three categories. The two main categories of "local" and "admitted" reinsurers require offices in

Brazil and cash funds held locally. The third category of “occasional” reinsurer, does not, but it requires a nominated agent for service of process in Brazil.

The regulations provide details of the reserves and guarantees to be presented by authorised reinsurers. For local reinsurers, the “minimum capital” requirement is R\$60 million (US\$37 million), which must comprise a minimum of 50% in cash or treasury bonds. There is also an “additional capital” requirement, not fully specified in the regulations, but generally stated as being based on the risks reinsured.

Admitted reinsurers are required to have minimum risk ratings of: BBB- (Standard & Poors), BBB- (Fitch), Baa3 (Moody’s), and B+ (AM Best). Their net assets must be valued at not less than US\$100 million. They must also maintain a foreign currency escrow bank account “linked” with the regulators, with a minimum of US\$5 million for underwriting all lines of business and US\$1 million for personal lines only.

In response to complaints from international reinsurers as regards the reserves set in earlier drafts, the regulations laid down what appears to be a more complex, and not clearly detailed, calculation of “weighted” premium and claims reserves to be deposited by admitted reinsurers. The “weighted” value of the reserves is based on the agencies’ risk ratings given to the reinsurer concerned. However, as it is the case regarding the requirement for local reinsurers to provide “additional capital”, further guidance is also needed from the regulators as to the calculation of “weighted” reserves.

Occasional reinsurers are required to have minimum risk ratings of: BBB (Standard & Poors), BBB (Fitch), Baa2 (Moody’s), and B+ (AM Best) and their net assets must be valued at not less than US\$150 million. In addition, an occasional reinsurer cannot be incorporated in a tax haven - one where income tax is less than 20% or company ownership is not open to public inspection.

The preferential offer and the new premium cession restrictions

The regulations provide that local cedents shall make a preferential offer to local reinsurers of, at least, the following percentages of reinsurance premium, for each placing: 60% until 16 January 2010, and 40% after 16 January 2010 (indefinitely).

Retrosurance appears not to be part of these limitations.

As part of the procedure for compliance with the preferential offer, local cedents must address “a formal enquiry” to one or more local reinsurers, containing the terms, conditions and all information necessary for the analysis of the risk. If there is any refusal, local cedents must offer the risk to all other local reinsurers. Time limits for local reinsurers to respond are laid down in the regulations and silence is a refusal.

As part of this system of preference, there is an innovation that local cedents may include in the formal enquiry to the local reinsurers, quotes obtained earlier from admitted or occasional reinsurer(s). So long as these quotes comprise at least 60% of the risk, and are on better price terms than those offered by local reinsurers, the regulations provide that the preferential offer requirement has been satisfied.

This innovation in the regulations is surprising. There was no indication in the CL that the preferential offer could be complied with in this way.

However, in contrast to this liberalisation, two restrictions on premium cessions have been introduced.

Firstly, in reinsurances, local insurers are not allowed to cede more than 50% of premium received in respect of risks bound in each calendar year (taking into account the global operations of the cedent). This restriction affects the whole reinsurance market, including occasional and admitted reinsurers.

Secondly, in retrocessions, local reinsurers are not allowed to retrocede more than 50% of premium received. However, surprisingly, this second restriction does not apply to occasional and admitted (the category under which Lloyd's has applied to operate) reinsurers.

This may give occasional and admitted reinsurers a competitive advantage against local reinsurers. Occasional and admitted reinsurers will be allowed to retrocede 100% whereas local reinsurers will have their retrocessions curtailed by the 50% limit.

It remains to be seen whether the regulators will ask the government to issue a decree imposing a third restriction applicable only to premium cessions made to occasional reinsurers. In the consultation process, the regulators indicated that they would ask the government to impose the following limits: in reinsurances, 10% of premium cessions to occasional reinsurers by local insurers, and, in retrocessions, 50% of premium cessions to occasional reinsurers by local reinsurers.

If this third restriction is imposed, then admitted reinsurers, not being subject to any restriction, will effectively have a further competitive advantage.

Contractual terms

Brazilian jurisdiction, follow the fortunes and claims cooperation clauses were all mandatory matters under the old IRB regime. Now, the regulations have adopted a more flexible approach. For instance, they are silent as to follow the fortunes clauses, which should allow the parties the freedom to negotiate their inclusion in reinsurance contracts.

A further example of this greater respect for the parties' freedom to negotiate their contractual relationships is the express permission for the "participation" of reinsurers in the adjustment of claims. This change may allow for a reinsurance contract to be subject to claims control by reinsurers.

Another important issue is the one concerning jurisdiction and applicable law. The regulations require that where disputes under a reinsurance contract are to be determined by a court, that court must be Brazilian and the contract be subject to Brazilian law. However, as a liberalising move, where arbitration is elected by the parties, the regulations appear to give the parties freedom to choose that their disputes are to be resolved in a foreign arbitration and subject to foreign law.

This move towards greater freedom reflects the ratification in 2002 by the Brazilian government of the New York Arbitration Convention and the ensuing support given by the Brazilian superior courts in upholding the parties' right to negotiate foreign arbitration clauses in their contracts. This right is expressly set out in the Brazilian Arbitration Act of 1996. Accordingly, international reinsurers should give serious consideration to the selection of a foreign arbitration agreement as such an agreement is likely to be upheld by the Brazilian courts.

In view of the greater liberalisation introduced by the regulations, they have been welcomed by the international market. However, the regulations are not as fully detailed as might have been expected. This gives rise to areas of

uncertainty which may discourage international reinsurers from entering the Brazilian market. International reinsurers must remain engaged in discussions with the regulators, if they are to take advantage of the business opportunities arising under a new system open to competition.

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