Latin America: insurance risk and regulatory developments

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Contents

Executive summary

Latin America's compound growth remains attractive and yet overall, insurance penetration rates still remain low in many countries. Particularly in life insurance, despite continuing economic growth and reduced poverty levels, penetration is low suggesting there is still significant growth ahead for the insurance sector. We have seen significant reforms across the region from both a fiscal and regulatory standpoint, in everything from capital and exchange controls to consumer protection. We believe a key challenge for insurers over the next decade, is navigating this rapid acceleration towards modern regulatory and operational realities successfully.

Around the world, regulator's are setting the expectation that insurers will raise their game. The trend is clear towards better risk management, better governance, more precise measurement of capital in a risk sensitive way, and more detailed and transparent reporting to regulators.

We presented our first report for Latin America in 2012, focusing on risk-based capital (RBC) and emerging regulations in four markets: Argentina, Brazil, Chile and Mexico. We have expanded our coverage and also added Colombia, Peru and Uruguay to our new 2014 overview.

In the past two years, each Latin American market has faced a different journey to a risk and economic value-based solvency framework. More open markets in the Pacific Alliance (Chile and Mexico) have enhanced their risk management processes, while Brazil is seeking Solvency II equivalence by 2016. Mexico's new law, modelled on Solvency II, is likely to be implemented ahead of the rest of the world. Peru and Uruguay have no immediate plans to pursue a Solvency II approach. Although both countries are attracting foreign investment, the market size and number of players are impeding regulation. With Argentina's high inflation and economic concerns, adopting an RBC framework in the short term is unlikely.

We present this report to help our clients better understand the trends and issues facing the growing economies of Latin America. The challenge remains that most insurers in the region are not well prepared for the expected changes in Governance, Risk management, Capital requirements and reporting. At EY we believe that effective risk management and the ability to quantify and price risks accurately are a core competence for a successful insurance company. We also observe globally that the leading insurers will typically look to define their own vision for their capabilities in these key areas, rather than simply following the iteration of each piece of regulation. Leading firms will also typically go on to deploy these capabilities more quickly and effectively across their businesses at the point of decision making and being ahead of competitors in this way is a source of clear commercial advantage.

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Argentina

Implications of risk-based capital for Argentine insurers

Introduction

The Argentine insurance market has made minimal progress in its approach to RBC in recent years. As other Latin American countries take steps toward Solvency II equivalence, Argentina is only superficially addressing this issue. In a country experiencing high inflation, tight regulation and fluctuating economic market concerns, RBC is only one in a long list of initiatives on the regulatory agenda of the Superintendencia de Seguros de la Nación (SSN).

Nevertheless, insurance is a fast-growing industry that continues to show resilience in premiums and tolerance for expansion in a challenging environment. Annual growth percentages are measured in Argentine pesos, so the inflation rate has a significant impact on those figures. As of 30 June 2013 (last fiscal year-end), there were 184 companies (108 in property/casualty) writing insurance in Argentina – with 29 new companies added in the past two years. International players continue to make acquisitions to enhance their positions in the industry. Growth has been most prominent in workers' compensation and motor insurance, producing increases of 42% and 35%, respectively, from June 2012 to June 2013.

Current state of play in Argentina

The complex, highly structured economic framework of Argentina has a strong influence on the insurance industry. While the country is the third-largest economy in Latin America, it also has one of the world's highest rates of inflation, projected by some economists to exceed 30% in 2014. Moreover, the Central Bank continues to hike interest rates and tighten monetary policy. These factors are encouraging heightened price competition within the industry, and making it more complicated to assess sufficient rates and interpret statutory gains (losses) and financial income (loss) disclosed by insurers.

Another issue that comes into play relates to specific lines of business and the technical losses they incur. Motor insurance, which accounts for over half of the premiums in the market, traditionally shows over a 10% technical loss, and workers' compensation presents an equal challenge.

Furthermore, the number of lawsuits in the Argentine market continues to escalate, making it difficult to predict the costs or value loss reserves. The high number of lawsuits is related to claims

for personal damages and disabilities, specifically for motor and workers' compensation insurance. This is compounded by the wide range of claims and the diversity of treatments that apply in different districts and court proceedings. With high claims and litigation rates weighing heavily on P&L statements, insurers need to determine how to manage these risks and still maintain a competitive position in the marketplace.

The nationalization of reinsurance a few years back has had no major impact. Motor insurance and workers' compensation are the two largest lines of business in Argentina, and they have no reinsurance.

The Argentine solvency system follows traditional measurement methods that are consistently applied to all lines of insurance and coverage.

Implementing capital requirements

The Argentine solvency system follows traditional measurement methods that are consistently applied to all lines of insurance and coverage. Under current regulations, insurers should show evidence of compliance with minimum capital requirements on a quarterly basis. This technical requirement, or "capital to be credited," is derived from the largest of three elements:

- A nominal capital amount allocated to each insurance line in which the entity or a group operates, with values adjusted periodically by the regulatory agency.
- An amount assessed by virtue of a certain portion of total premiums issued over the past 12 months in all lines, adjusted by the risk-withholding percentage for the past 36 months (calculated on the basis of the claims paid in such period). This may not be less than 50% of the risk-withholding percentage, which is calculated as net claims paid/gross claims paid.
- An amount calculated on the basis of a certain portion of total claims accrued over the past 36 months in all lines, adjusted by the risk-withholding percentage mentioned above.

The largest of these amounts is compared against the entity's computable capital, which results from revising shareholders' equity against the application of the criteria established by the regulatory agency. The excess or shortfall in computable capital against capital to be credited indicates whether the entity yields surplus or deficit, respectively. In case of a deficit in minimum capital, the entity should file a plan with the regulatory agency. This may include capital contributions, merger into another entity, intervention by authorities, portfolio assignments or transfer of certain assets and liabilities to another insurer and/or trust.

The SSN has taken a tolerant posture in implementing this regulation. As a result, only a few insurance companies (primarily in workers' compensation) are still showing a minimum capital deficit.

Adopting Comframe

The Argentine solvency system follows traditional measurement methods that are consistently applied to all lines of insurance and coverage.

Under Argentine law, the SSN has the power to determine the assets in which organizations are allowed to invest. Argentine insurance companies are required to invest a minimum of their total investments (18% in P&L, 15% in life and 8% in workers' compensation) in financial assets aimed at financing medium- and short-term infrastructure projects in Argentina. The SSN also analyzes voluntary liquidations, and insurers are required to file documentation proving the existence of funds to cover their liabilities.

An early-warning system has yet to be introduced that would trigger signs of insolvency within an insurance company. It is one of the measures being developed within the strategic plan currently led by the SSN. The first warning is triggered when the statutory reserves reach a minimum limit; the second, when reserves are insufficient; and the third, when a loss appears imminent. Debt plans are implemented based on this system, and if they are not complied with, authorization to operate is annulled.

The SSN has not been forthcoming in publicly sharing information about its RBC initiatives. Solvency is not as high on the agenda as other issues, such as market growth and consumer protection. They say they are moving to change some of the regulations relating to technical reserves, which will impact the evaluation of capital. In fact, this is basically taking a traditional route to Solvency I. Measures are being addressed that include references to solvency and provisions for risk, but they do not come close to a Solvency II scheme. While the growing Argentine life and pension insurance market stands to benefit from Comframe, applying that methodology does not appear to be feasible anytime soon.

What lies ahead for Argentina?

The SSN launched a strategic insurance plan two years ago and invited industry participants to share their vision for 2012–20. Some of the entities held by European insurance companies recommended that the adoption of an RBC system be included as a provision. So far, no progress has been announced.

The creation of an internal body by the insurance companies to assess their solvency is among the measures that could be announced within the following months as a result of the ongoing strategic plan. It is not yet in place.

Clearly, any changes or improvement in terms of Comframe will be minimal in the months ahead. With elections on the horizon for 2015, the political climate is of concern. Political change could lead to further advances in adopting a RBC and economic framework.

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Brazil

Implications of risk-based capital for Brazilian insurers

Introduction

The Brazilian insurance market continues to achieve double-digit growth. The industry is witnessing a series of mergers and acquisitions and the arrival of multinational insurance and reinsurance companies, mostly from Europe. In addition, the sector experienced the largest initial public offering in the world last year, when BB Seguridade raised approximately US$5.75 billion in the BOVESPA stock exchange.

Although national bancassurance players dominate the Brazilian insurance market, international insurance companies continue to grow at a higher rate through M&A and strategic alliances.

Given the continuous growth in the market, the Brazilian regulator, Superintendência de Seguros Privados (SUSEP), is working with the European Insurance and Occupational Pensions Authority (EIOPA) to achieve Solvency II equivalence in Brazil. This will facilitate the investment of European insurance companies in Brazil and Brazilian companies in Europe. SUSEP will sign an agreement that will adopt Solvency II rules partially or fully by 2016, based on a comparative study that EIOPA will perform to measure Brazilian regulation against the Solvency II regime.

Current state of play in Brazil

As the regulatory environment has evolved over the last two years, SUSEP has invested in the development of a standard RBC framework similar to Solvency II.

In 2013, SUSEP regulated long-term insurance contracts (life and pensions) and established a capital charge for operational risk, in addition to short-term contracts and credit risks that were subjected to regulation a few years ago. The effect of this new risk-based standard was to increase the required operating capital in the Brazilian insurance market.

SUSEP announced the development of three additional initiatives (the final versions still to be issued) in 2014 to reinforce the RBC measures that would be comparable to Pillar I of Solvency II. These include:

- Market and liquidity risks: SUSEP has issued draft regulation on market risk, comparable to Solvency II, covering interest rate risk, equity risk, commodities risk and currency risk. This includes assets typically covered by the Solvency II spread risk module, such as corporate bonds (covered by the credit risk module) and concentration risk, which is not considered a major risk for insurers.
  - A quantitative and qualitative study for major insurance companies in Brazil followed. This showed that most insurers lack asset liability management (ALM) and that an effort to link the investment function with the actuarial function is necessary for a sound ALM and can contribute to reduce interest rate mismatches and consequently capital charges.
  - It is expected that market risk will be regulated until the end of 2014 and that capital charges will be applied following a phased method (0% until the end of 2016, 50% in 2017 and 100% for 2018 and following years).
  - As for liquidity risk, the regulator will require insurers to increase their liquid asset margins in relation to the minimum capital required by 20% in 2015.
- Operational risk: SUSEP has issued draft regulation (currently under debate by the industry) that companies above a certain level of premiums need to implement an operational risk loss database and disclose these figures periodically to the regulator. The objective of this loss database is to estimate the parameters of the future standard formula of operational risk to be applied in Brazil. Most companies are leveraging this regulation to establish a more robust operational risk framework to reduce operational losses within their organizations.
- Internal models versus the standard formula: SUSEP has issued regulation that allows companies to implement internal models and substitute the standard formula. However, the process of internal model approval in Brazil is still unclear.

"Our latest Brazil Capital Confidence Barometer shows Brazilian companies are poised for growth: confidence is reflected in Brazilian executives' strategic approach to optimizing capital through operational efficiency, increased margins and cost control."

–Fabio Guerra Pires, Partner, Transaction Advisory Services, Ernst & Young Assessoria Empresarial Ltda

Enterprise risk management and ORSA

A growing demand for improved enterprise risk management (ERM) is increasingly present on the agendas for both regulators and insurance executives.

Most companies in Brazil are implementing and embedding RBC rules. However, a major issue is how to integrate risk within the business and strategic plans.

Given RBC rules, companies must define new strategies for asset allocation, based on robust ALM techniques, product development, reinsurance and strategic planning (M&A, strategic alliances and portfolio changes). This is more important as the maturity in the market grows and clients demand more sophisticated offerings, such as life and pension products with longer-term guarantees (e.g., whole life insurance with leveled premiums and life annuities) or universal life.

Companies in Brazil are realizing that they need to integrate product, actuarial, investment and risk management functions in a more holistic view in order to realize the benefits of risk management within the business. This will also enable insurers to explore market opportunities, such as better commercial offerings for consumers in consolidated markets or new and innovative products.

To achieve this, companies must have a solid risk management framework that focuses on improving data quality and data governance. This needs to be combined with well-informed risk-evaluating intelligence and technology throughout the processes of underwriting, risk classification, pricing and reserving. Moreover, risk governance and culture are still key improvement areas. It is important to spread the culture of risk management across other functions of the business, in order to realize the benefits.

On the regulatory side, SUSEP has stated that, after Pillar I initiatives in Brazil are regulated, companies will have to implement sound practices of risk management that are linked within the business through ORSA. This will represent a major transformation in how insurance companies will operate in Brazil.

A growing demand for improved ERM is increasingly present on the agendas for both regulators and insurance executives.

Pillar III and solvency reporting

SUSEP requires companies to disclose statistical, actuarial and financial reporting data on a monthly basis. Nevertheless, market reporting by insurance companies to the public is still based on financial information and generally accepted accounting principles. It is necessary to develop more detailed information for the stakeholders and public in general about risk and solvency requirements.

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The way forward in Brazil

SUSEP's agenda in the next few years is consistent with Solvency II. The regulator, under a new leadership, is taking important steps to implement RBC standards in Brazil. These are consistent with Europe's regulation, and the market has high expectations for this paradigm shift. The agreement with EIOPA for Solvency II equivalence will be a major milestone for risk-based supervision that is expected to take place at the end of 2014.

It is also expected that standard formulas for Pillar I will be implemented by year-end. It is unclear when SUSEP will regulate the process for application of internal models, although the legislation to substitute standard formulas for internal models has been developed. A growing demand for improved ERM is increasingly present on the agendas for both regulators and insurance executives.

SUSEP has stated that the legislation of Solvency II Pillar II and regulation for group supervision should be a focus within the next year. Taking that into consideration, the major transformation for insurance companies will be how to embed risk management into decision-making processes; provide the technical know-how, risk governance and culture; and manage data more effectively.

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Chile

Implications of risk-based capital for Chilean insurers

Introduction

The insurance market in Chile continues to shift from its present regulatory framework to a more sophisticated RBC approach to solvency assessment that better reflects current industry risks. New methodology proposed by the Superintendencia de Valores y Seguros (SVS or Superintendency of Securities and Insurance) is an important step toward building an integral and holistic RBC model.

The Comframe capital framework implementation requires each risk category to be managed individually, with most supervision on a product-by-product basis. Most insurers will need to improve their risk function or implement a holistic approach to risk management. Also, local skilled resources are scarce for the level of technical knowledge imposed by this regulation. Many will need to develop better data analytics, systems and precise risk measurement if they are to increase capital efficiency and profitability.

Chile is one of the more stable markets in the region, primarily because of tight controls over insurance products and asset portfolios. This stability is essential in a market that offers rich growth potential. While the ease of doing business in the country presents an opportunity, product expansion remains an emerging challenge due to a lack of insurance product awareness and consumer perceived value.

Current state of play in Chile

Increasing corporate income tax rates, withholding tax on dividend distribution and a capital gains tax on the transfer of stock are a few of the key tax measures being implemented in Chile and other Latin American countries.

As these reforms evolve, the SVS continues to implement a revised regulatory framework. An initial draft was introduced in Congreso Nacional in September 2011, approved in October 2012 and passed to the Senate. Modeled after the experiences of Canada, the US and Australia with Solvency II, the document addressed the minimum requirements for solvency and capital under Pillar I and the adoption of governance, risk management and greater transparency under Pillar II.

In January 2014, the SVS issued a second draft describing the conceptual framework for RBC. This details the methodology for the second Quantitative Impact Study (QIS2) that was released in May and is based on QIS1 results and feedback from the insurance industry. The SVS plans to conduct future application exercises in order to calibrate and improve this model.

The most significant changes to the new proposed SVS methodology include:

- Insurance technical risks for "first group" companies; the new model abandons the solvency margin and adopts a model that is similar to the one established in Solvency II
- A drastic improvement in the interest rate risk model to generate the stressed advanced series trust for life annuities
- Fundamental adjustments for operational risk that reduce the maximum capital requirement percentage and increase the premium growth percentage to a level consistent with the Solvency II formula

Various aspects of the current model will improve the regulatory equivalence with Solvency II. Other areas have yet to be developed, and risks not covered by this methodology must be quantified to reflect integral risk management within a company. In spite of efforts to embed risk and capital management frameworks into their organizations, most insurers have yet to establish a robust risk management infrastructure or designate a chief risk officer.

While some countries (Bermuda, Switzerland and Japan) are engaging in a "full equivalence" Solvency II assessment process, Chile has expressed an interest in "temporary equivalence," which applies only to reinsurance and group supervision activities.

The results of the EY 2013 Latin American Outbound Expansion Survey and our qualitative research show that Chile is more outwardly focused than most Latin American countries.

Benefits of a Pillar II approach

Chilean insurers would benefit from a Pillar II approach that affords improved governance, informed decision making and enhanced risk management information. Other advantages:

- Management and other stakeholders will have more confidence in understanding the sources of risk.
- Different parties responsible for making (or averting) risk-taking decisions will not be using different metrics and information to make those decisions. A "single version of the truth" within the business should drive consistency in decision making that is better linked to risk appetite.
- While Pillar I in the Solvency II framework looks at a 12-month time frame, insurance companies (especially life insurers) run their businesses on a much longer cycle. Management has the responsibility to demonstrate a deeper understanding of risks than they have in the past, which can be achieved through the Own Risk and Solvency Assessment (ORSA) process.

Chilean insurers would benefit from a Pillar II approach that affords improved governance, informed decision making and enhanced risk management information.

Recent events have highlighted the need to understand business risks over the long term and the implications for how insurance companies are managed. Some aspects of business might transform significantly as a consequence of changes to the relative importance of performance measures.

A cultural shift presents challenges

The current state of risk management among Chilean insurers suggests the need for a cultural shift to adopt Pillar II initiatives. Insurance companies will have to invest significant time and resources to educate the board and senior management around these initiatives. This is particularly critical at a time when there is a limited pool of talent from which to hire risk professionals who understand insurance. Shortages may also be apparent at the most senior company levels given the prominence assigned to the role of governance. This will require a change in the mindset of top management.

Risk management activity must be forward-looking in its risk assessments, which is an essential feature of Pillar II. This touches on all key functions from product pricing to reinsurance, effective management decisions, performance management, mergers and acquisitions, portfolio management, and business planning. These and other activities need to be informed by a Pillar II-compliant view on the risk exposure levels of the business.

There is also room for more forward-looking stress testing to support the business strategy and help drive contingency planning. This would require a major transformation for Chilean insurers to benefit from Pillar II-type initiatives.

Pillar I in Chile

The methodology for calculating RBC in Chile is currently being refined. The SVS has issued two consultative papers that define a tentative model. The methodology so far is inspired by Solvency II; however, it is not identical. There are special treatments for certain products such as lifetime fixed annuities and unit-linked products. Other considerable differences with Solvency II might inhibit the regulatory equivalency of the Chilean model.

The Chilean regulator is expected to further adjust the methodology and publish more consultative papers before the Government approves the new capital model.

One of the major challenges, for both Pillar I and Pillar II, will be the availability of skilled resources. Another hurdle will be getting the appropriate granularity of data to perform credible analysis. Furthermore, to successfully implement Pillar I, Chilean insurers will need to invest significantly in IT, finance and actuarial systems.

Taking a more proactive stance

Currently, companies are adapting to the new regulatory framework. As the SVS pushes forward the second quantitative assessment, insurers are gradually accepting the changes. Still, there is a strong sentiment in the industry that there is no need to adopt a new capital model and thus increase capital requirements.

Some companies are adopting a more proactive approach. The local regulator has communicated intentions to reward those organizations that have implemented better risk management practices. Such rewards will be reflected indirectly in capital requirements. The SVS has also communicated the consequences of having a poor solvency assessment, which is directly correlated to the soundness of the company's risk management practice.

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Colombia

Implications of risk-based capital for Colombian insurers

Introduction

Colombia enjoys strong economic growth and enormous potential for financial stability over the next three to five years. GDP growth is about 4% a year, ahead of the average for the region. This is driven by stronger activity from foreign investors, a stable macroeconomic environment and a growing middle class. The free trade agreements that Colombia has engineered with major world markets is one example of the tremendous potential the country offers.

Insurance regulation is moving toward a more risk and economic value-based solvency framework, with tightened capital market regulations. As a result, Colombia is ahead of many global rapid growth markets in reforming regulatory processes, protecting investor rights and cross-border trading to increase the ease of doing business for small companies.

Recent rules that allow foreign insurance companies to establish branches and operate as local insurers have changed the complexion of the Colombian market. Global industry players are entering, buying local insurers or considering start-up companies. This should encourage increased capacity, product diversification and greater competition. Colombia's premium growth was US$8b in 2013, and rate reductions of up to 10% are expected for property and life/accident insurance in 2014.

Current state of play in Colombia

The Government of Colombia introduced International Financial Reporting Standards (IFRS) in 2009. This was a significant transition from the Colombian Generally Accepted Accounting Principles (COLGAAP) that had been the insurance accounting standard for many years.

In 2013, the Ministry of Finance modified the provisions for technical reserves for insurance companies in Colombia and established a two-year transitional period regarding IBNR reserve and a one-year transitional period regarding the rest of reserves to meet the new IFRS requirements. This transitional period will start when Superintendencia Financiera de Colombia (SFC) issues this regulation. As of today, this regulation has not been issued by SFC.

In recent years, other regulations have evolved in Colombia. These include an equity project around counterparty and market risk and an investment scheme to change certain regulatory limits and discriminate between life and general insurers. Corporate income is taxed at 25% and withholding tax on both dividends and royalties at 33%. In addition, there is a value-added tax (VAT) of 16% for insurance premiums, excluding those related to life or health insurance and education. Insurance contracts are also excluded, as are special health services and disability insurance premiums.

Colombian legislation limits the operation of banks and other financial institutions by separating fiduciary, investment banking, commercial loans, leasing and insurance services from banking.

Moreover, Colombia allows 100% foreign ownership of insurance company subsidiaries. These must have a local commercial presence to sell policies other than those for international travel or reinsurance. The regulator sets annual minimum capital requirements to establish an insurance company in the country.

Comparison of COLGAAP and IFRS

IFRS was formally introduced 1 January 2014, with full implementation expected by 31 December 2015. The major area of difference between IFRS and the current COLGAAP is the treatment of technical reserves.

The SFC requires insurers to have the following technical reserves:

> One secret of Colombia's success is the openness of its economy. EY's 2012 Globalization Index ranks Colombia the 40th most open economy in the world.

- Unearned premium reserves, which are set as a value to deduct the amount of net premium retained to protect the portion corresponding to the risk premium
- Mathematical reserve, defined as the difference between the present value of future risk by the insurer and the present value of net premiums payable by the policyholder
- IBNR, or the reserve of incurred but not reported claims
- Provision for outstanding claims, which aims to ensure payment of claims incurred that have not been paid during the financial year
- Deviation from claims reserve to cover highly fluctuating, cyclical or catastrophic risks
- Loss declared reserve to record the estimated amount of declared claims that have not yet been paid
- Special reserve to cover lines of business risk in life companies, according to local regulator guidelines

Insurance companies also need to consider these aspects:

- **Discounting provisions:** defined under IFRS and not under COLGAAP
- **Measurement of provisions:** range of possible outcomes; best estimate of obligation should be accrued under IFRS
- **Short-duration contracts:** non-life or short-term insurance transactions are accounted for on a deferral and matching basis for COLGAAP and IFRS
- **Long-duration contracts:** under IFRS, most local GAAP life insurance accounting models will recognize premiums when received and measure insurance contract liabilities under a discounted cash flow approach; COLGAAP recognizes mathematical reserves according to actuarial calculations
- **Measurement of insurance liabilities:** current estimates of future cash flows under insurance contracts are measured each reporting period under IFRS; this contrasts with COLGAAP, which measures the obligation under retained risk
- **Deferred acquisition costs:** no guidelines under IFRS for recognition and measurement of deferred acquisition costs
- **Unbundling of service and deposit components:** treatment is defined under IFRS and not under COLGAAP

Solvency margins

Insurance regulation is moving toward a more risk and economic value-based Comframe, with tightened capital market regulations.

The minimum capital required for insurers in Colombia has not changed; however, there is a new way to calculate solvency capital. The SFC calculates solvency margin for both life and non-life insurance companies as follows:

Primary capital	Secondary capital	Technical equity	Capital adequacy	Margin of solvency	Guarantee fund	Excess or shortage
(1)	(2)	(3) = (1) + (2)	(4)	(5) = (3) - (4)	(6) = (4) x 40%	(7) = (3) - (6)

"Law 2954 of 2010" states that insurance companies must maintain technical equity that is at least equal to the capital adequacy. Therefore, the margin of solvency described in the chart should always be "an excess percentage" or about 100%.

The law also provides details on how the technical equity and capital adequacy should be calculated:

Technical equity = primary capital + secondary capital

Primary capital = paid capital + legal reserves + additional paid-in capital (composed of previous-year losses and some specific investments)

Secondary capital = some reserves (statutory and events) + 50% of some assets

Capital adequacy = underwriting risk, asset risk and market risk

The elements of capital adequacy are treated differently for organizations and lines of business. For general or non-life insurance companies, underwriting risk is the higher amount of a calculation based on premiums or a calculation based on claims. For life companies, it is the sum of mathematical reserves (a range of 6% of mathematical reserves to 85% of ceded reserves) whether it applies or not. And, for lines of business, it is the sum of a calculation based on premiums, claims and mathematical reserves.

The other two components of capital adequacy are asset risk, which depends on the classification of assets and a rating with a corresponding "weight factor," and market risk, which is based the value at risk. The latter is a local regulation that applies only to general insurance companies.

Insurance regulation is moving toward a more risk and economic value-based Comframe, with tightened capital market regulations.

The way forward in Colombia

As an insurance market, Colombia presents opportunities for doing business that far outweigh the risks. In spite of relatively low insurance penetration, the industry has been expanding at a rate that has exceeded 10% annually for the past four years. Furthermore, the economic and regulatory environment has been favorable to foreign investment and market expansion. One large US industry player recently established a reinsurance operation in Colombia and another announced plans to form a direct insurance company within the next few years.

The country continues to reform regulatory processes around solvency margins, IFRS technical reserves, dividends to shareholders, tax treatment of investments, and foreign ownership of financial institutions and insurance companies. Colombia is clearly headed toward more complex RBC assessments.

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Mexico

Implications of risk-based capital for Mexican insurers

Introduction

The Mexican insurance market is the second largest in Latin America. As of December 2013, gross premiums totaled $334.19 billion Mexican pesos or approximately US25.6 billion, an increase of 10.7% over the prior year, this increase includes the effect of a large biannual policy of the government. Despite having one of the lowest proportions of insurance penetration in the region (almost 2% of GDP), Mexico continues to grow above the country's nominal GDP. New insurance laws and Solvency II regulations are leading to market consolidation, as well as growth in specialty and consumer product lines. The high demand for life insurance is reflected in individual life premiums which rose 23% in 2013, following a 19% increase in 2012 basically for the success of some savings products.

The regulatory framework in Mexico is evolving toward a more sophisticated risk-based capital approach. A proposed Solvency II – type insurance law has been under review by the Mexican regulator, Comision Nacional de Seguros y Fianzas (CNSF) and the Mexican association of insurance companies, Asociacion Mexicana de Instituciones de Seguros (AMIS) since the second half of 2008. The Mexican Congress approved the new regulation in April 2013. Quantitative Impact Studies (EIQ) and Qualitative Impact Studies (Cualitativo or EIC) are moving forward and new accounting principles are under discussion. Legislation in the country continues to advance and is likely to be implemented ahead of the rest of the region.

Current state of play in Mexico

When the Mexican Congress approved new regulations, insurance companies were given 730 days to comply, with an effective date of April 2015. To measure the economic impact of these regulations, three EIQ studies were scheduled: late in 2013, February–April 2014 and May–June 2014.

For EIQ1, the regulator (CNSF) provided insurance companies with a software package to calculate the Mexican standard formula for capital requirements; the software was updated for EIQ2. The EIQ1 challenge for insurers was to know what information the regulator required and feed it into the system. For EIQ2 and EIQ3, the struggle was not with the information, but with the quality of results. Some insurance companies are also having difficulty understanding and applying complex, stochastic models to the standard formula. CNSF's software package is highly sophisticated and enables insurers in Mexico to perform simulations that may not be available in other countries.

As part of the Mexican regulatory agenda, three EIC studies were released beginning in May 2013. For EIC2, the CNSF posed 121 questions and asked 40 insurance companies to respond within a

given time frame. AMIS analyzed the total results to evaluate the quality of the answers and test them by work stream (internal audit, risk management, actuarial function, internal controls, etc.) Most companies anticipate that they will be able to eliminate their gaps by April 2015 when the new regulation will become mandatory.

Benefits and challenges of implementing Pillar II

Insurance companies need to establish an effective system of enterprise risk management (ERM) and corporate governance to comply with Pillar II requirements for Solvency II. The experience in Mexico is very similar to that of European Union countries where insurers are fulfilling requirements for an effective ERM system but still finding gaps.

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Most organizations have not yet reached the minimum level of Solvency II compliance, particularly in relation to the Autoevaluacion de Riesgos y Solvencia Institucionales (ARSI or Mexican equivalent of ORSA). ARSI implementation readiness encompasses a wide range of assessment activities, including projecting capital and solvency within a three- to five-year timeline, designing stress and scenario tests, assessing governance effectiveness, and integrating ARSI results into the strategic business planning process.

Other significant Pillar II activities include:

- A document containing ARSI results must be submitted to the regulator as part of a corporate governance report.
- Management and the board must review the insurance company's risk management activities at least once a year.
- The risk management framework must include risks set forth for calculating the Solvency Capital Requirement and other risks not included in this calculation.
- The ERM framework must enable insurers to understand and control the origin and nature of different types of risks using qualitative and quantitative analysis.

Insurance companies should establish an effective and permanent internal control system. Many organizations may have a framework on paper that was developed for an international entity. However, they do not know how the internal controls, risk management and corporate governance systems are embedded and the measures needed for compliance with the regulations.

Pillar I in Mexico

The results of the EIQ studies will determine whether insurance companies need to develop an internal model and will help to calibrate the market consistent technical reserves required for the regulation. Many insurers have chosen not to consider an internal model because they expect to be using the standard model for the next two years while the new regulation is being implemented. Larger multinational companies are still developing internal models. However, many have found that they are not as good as the standard models and are not prepared to work through the issues that are involved with using them.

EIQ3 allowed some companies to have greater insight into the technical background of the Mexican standard formula for capital requirements. Most companies do not know which information to use to measure risks and these results will help them evaluate which databases are required for the standard formula. All three EIQ have been measured as of 2012, so a measurement at different reporting date might be suggested to evaluate the volatility of own funds.

Insurance companies face a number of issues including the development of an economic balance sheet, which is the basis for these capital requirements. Currently, the standard formula for capital requirements is greater and more complex than the Solvency II standard model. Moreover, few companies have the robust actuarial systems to calculate technical reserves. In most cases, technical reserves will be decreasing under the new regulation. In the move from Solvency I to Solvency II, insurers never expected lower capital requirements than they have now.

Other new accounting principles

CNSF is formulating new accounting principles for first time adoption in April 2015. The regulation differs significantly from International Financial Reporting Standards. One of the topics under discussion is volatility in the balance sheet due to market valuations in investments and liabilities (no contractual service margin included in accounting principles).

The regulator has deemed that there will be only one set of accounting information for insurance companies. This means the economic balance sheet will be prepared for all purposes, leading to volatility in the balance sheet that would be reflected on P&L. Another issue is that Day 1 for implementation will be April 2015. When insurers file their P&L statement, they will have three months under one set of requirements and nine months under another. Thus, information will appear differently than if it were reported on an annual basis. Finally, the CNSF is creating a new account on the balance sheet in equity that is intended to absorb the effect of changes in discount rates but this has yet to be released and will be a hot topic for discussion.

The way forward in Mexico

Passage of the new regulatory framework is another step toward a Solvency II regime in Mexico. As stronger requirements for corporate governance, ERM and risk-based capital evolve, insurance companies are focusing more on compliance than achieving a robust level of data quality and controls.

Some of the proposed requirements will lead to operational challenges. For example, one mandatory change will require companies to present their balance sheet and P&L statement and the whole set of disclosures on their websites quarterly, leading to more frequent production of financial statements and accompanying disclosure notes. The industry feels that some of the information it will now disclose is not useful for clients, and broker agreements and commissions are risky to share with competitors. In spite of the diverse issues, the future is promising for insurers that can align regulatory initiatives with growth strategies.

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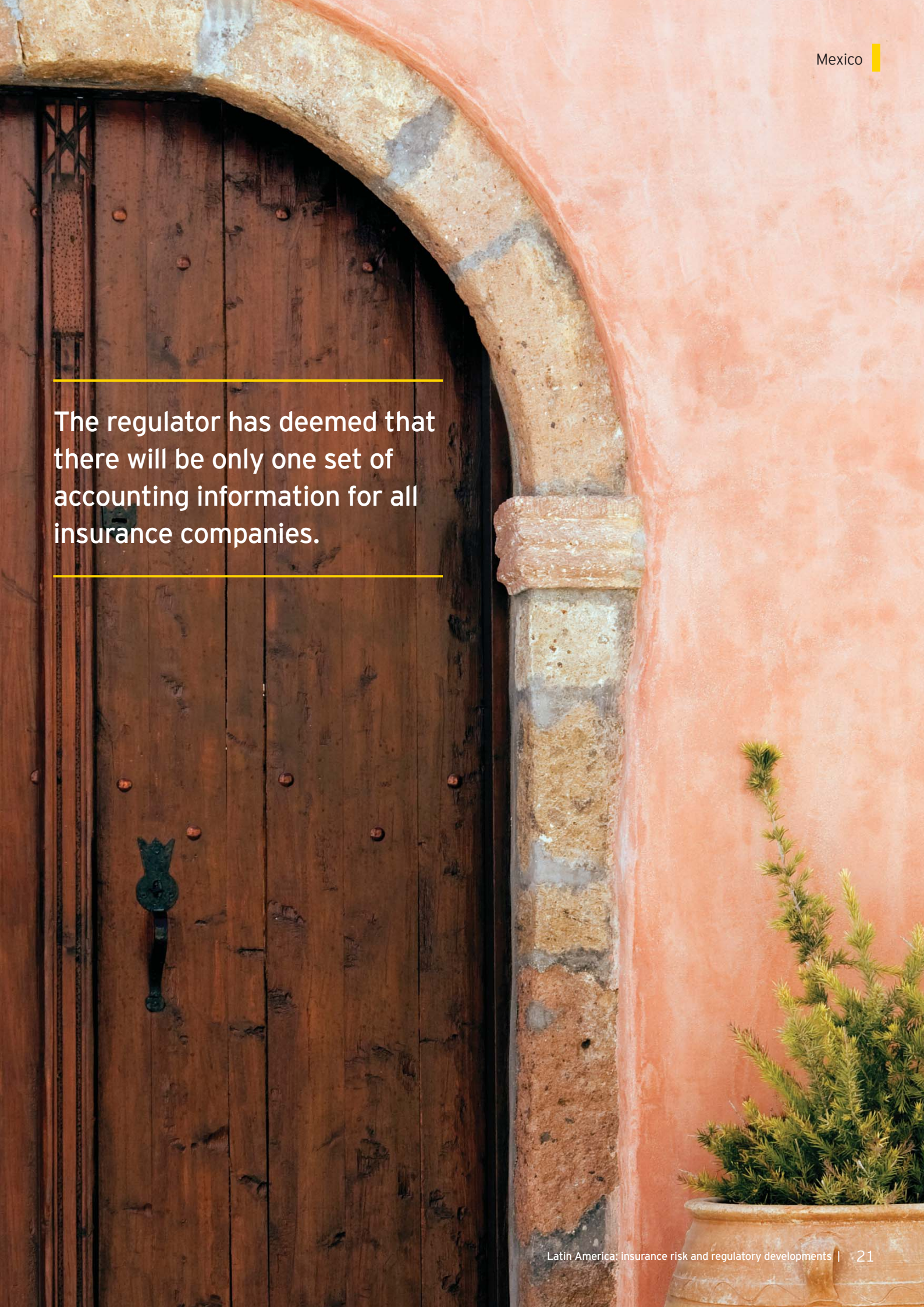

The regulator has deemed that there will be only one set of accounting information for all insurance companies.

Peru

Implications of risk-based capital for Peruvian insurers

Introduction

Peru's steady economic growth and expanding middle class are attracting new business and opening doors for insurance companies. The Peruvian economy is supported by rapid growth in investment, low inflation, strong economic fundamentals and an annual GDP growth rate of nearly 6%. The country has an investment rating in Latin America that is second only to Chile and offers a favorable legal framework for foreign investors. The financial sector, including insurance, is second only to mining (gold, zinc and copper) in direct foreign investment.

In the last decade, insurance industry sales in Peru have grown more than 200%, from PEN2,700 million (approximately US$776 million) to PEN9.069 million (approximately US$3,355 million) in 2013. As of December 2013, 40.4% of total net premiums were from general insurance, 13.5% from accident and health, 21.2% from life insurance, and 24.9% from the private pension fund system. It is important to note that only approximately 16% of the urban population has private insurance and 18% has health insurance – and this number has stagnated over the past five years.

The insurance market is highly concentrated in Peru, with 2 of the 15 insurance companies accounting for 60% of total gross written premiums. Overall, insurance penetration rates remain low, as they are in many other Latin American countries.

Current state of play in Peru

Financial services institutions (banks, insurance companies and pension funds) in Peru are regulated by the Superintendencia de Banca, Seguros y AFP (SBS). In recent years, the SBS has recommended a series of changes in the regulatory framework of the insurance industry inspired by the Comframe parameters. However, Comframe has not yet been implemented, and the regulatory agency has set no specific time limit to do so.

In terms of other legislation, a new policy was proposed in March 2014 to modify the registration process for investment funds to be eligible for investment by Peruvian pension fund managers (AFP). Presently, investment funds must apply to the SBS for approval, but under the new regulation, which became effective in August 2014, they may seek approval directly from the AFP.

Adopting Comframe or its equivalent

In recent years, the Peruvian regulator (SBS) has been organizing seminars to discuss the implications of adopting Comframe or an equivalent framework similar to that of other Latin American countries. At present, however, there is no a specific regulation in this matter.

The SBS has addressed issues around solvency, credit risks and technical risks affecting insurance companies. In 2008, it issued Resolution SBS Nº 037-2008, "Regulations for Risk Management," which defines comprehensive risk management as a process, implemented by the board, management and staff and applied across the enterprise. The aim is to identify potential events that may affect the organization, manage them according to their risk appetite and provide reasonable security in order to achieve strategic, operational, financial and compliance objectives.

The comprehensive risk management legislation proposes a COSO ERM approach that focuses on the internal environment; identifies and evaluates risks; and determines monitoring, controls and treatment, and the information to be communicated. The resolution also requires insurance companies to define methodologies for risk management, such as insurance risk, credit risk, strategic risk, liquidity risk, market risk, operational risk, reputational risk and any other risks to which these companies could be exposed.

Other SBS resolutions

In August 2006, the SBS issued Resolution SBS Nº 1124-2006 to regulate equity requirements for insurance and reinsurance companies. This states that organizations must establish solvency equity to support technical risks, such as inadequate underwriting policies, inappropriate use of technical or actuarial bases in calculating premiums, and insufficient reserves or reinsurance coverage. Moreover, a warranty fund was created as an additional backup for companies to deal with investment and other risks not covered by the solvency equity.

This resolution was amended in May 2014 by Resolution SBS Nº 2904-2014. No modification was made to solvency equity or the warranty fund. Other aspects that were revised include the need to establish additional effective capital by economic cycle, which has a progressive adaptation period that starts this year and ends in 2017.

The way forward in Peru

Peru's favorable investment climate, stable economy and business environment are attracting insurance companies to a more competitive market. An expanding middle class and strong regional growth is driving demand for insurance protection.

As Peru adopts best practices for reserves, investments and capital requirements, it also presents a favorable legal framework for foreign investment and regulation that protects investors. *Forbes* ranks Peru as one of the best countries for business in Latin America, based on credit, investment potential, tax structure, cross-border trade and other business factors.

This comes amid a push toward industrial development. Over the past decade, the country has become a world leader in gold, zinc and copper extraction. However, falling commodity prices are encouraging manufacturing, greater industrialization and modernization – all positive signs for the insurance industry.

As we look at the opportunities, we must also address the regulatory changes that are driving the impressive growth. What are the implications of risk-based capital for Peruvian insurers? Many Latin American countries have distinct views of the proposed single standard, yet the future of this regulation for Peru is unknown. A Presidential election is slated for 2016, but there are no indications that a Comframe or an RBC framework will be on the agenda for this or a new administration anytime soon.

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Many Latin American countries have distinct views of the proposed single standard, yet the future of this regulation for Peru is unknown.

Uruguay

Implications of risk-based capital for insurers in Uruguay

Introduction

Uruguay is a small country with stable economic growth, expanding tourism and rising disposable income. It was one of the few countries in Latin America that was able to avoid recession in 2008, and it continues to grow with an economy based largely on exports of commodities like milk, beef, rice and wool. It is home to some of world's largest banks and financial institutions that maintain branches there and was fortunate not to experience the impact of the global financial crisis or ensuing government intervention.

Although the Uruguayan insurance market is highly competitive, it has no more than 15 companies competing for market share. The largest in the country is Banco de Seguros del Estado (BSE), a Government-owned insurer with about 65% of the market share as of December 2013.

Gross written premiums for the insurance industry totaled UYU21.6 billion (US$1.1 billion) in 2012, with a CAGR growth rate of almost 19%. Motor insurance and general liability insurance were leaders in the non-life segment. An increase in demand for pension products contributed to the significant growth in the life segment.

Current state of play in Uruguay

No changes in local regulation related to Comframe have been introduced recently. Capital is calculated currently as a factor of premiums and claims, with no consideration for the risk factors that Comframe prescribes.

In terms of level of sophistication, most insurance companies do not possess a robust risk management infrastructure. Risk processes are viewed as a way of complying with regulatory requirements, with value primarily driven by commercial activities. In regard to market discipline, insurance companies publish their audited financial statements on the website of the Central Bank of Uruguay annually and publish unaudited information quarterly.

In Uruguay, accounting standards are set by the Government, which has created Comision Permanente de Normas Contables Adecuadas as an advisory body. The Colegio de Contadores, Economistas y Administradores del Uruguay is the main technical resource within that group and has been instrumental in the application of IFRS. Uruguay adopted IFRS (as it is translated into Spanish) for banks, insurance companies, mutual funds and other financial institutions in 2014.

Insurers also face accounting and tax issues, such as a value-added tax or VAT, capital gains taxes, and individual and corporate income taxes. While government policies promote global investment and

trade, capital markets are underdeveloped, and there is substantial state involvement in the economy. Government debt is also a lingering issue that is constraining growth in the insurance market.

No roadmap for Pillar I

RBC in Uruguay is currently not on the agenda for insurance companies or regulatory bodies. A minimum capital amount is calculated for premiums and claims, but the fair value of assets and liabilities are not considered.

One of the major challenges of implementing Pillar I in Uruguay will be the availability of talent and resources, especially for the valuation of reserves. There is a high demand for analytic skills, underwriting capabilities and technical expertise at a time when few universities in Latin America offer degrees in specialized areas such as risk management. The regulator has offered no short-term plans to address this talent shortfall.

Pillar II and Pillar III

Comframe proposes an effective system of corporate governance and ERM that is integrated into the corporate structure of the company. The regulation in Uruguay appears a bit far from this. In actuality, the external audit function is responsible for evaluating the internal controls and mechanisms that will prevent money laundering within the company.

The major challenges relating to Pillar II are the organizational structure of companies, the limited size of the insurance market and the small population of the country. Another key factor is the related costs associated with implementing enhanced risk management and improved corporate governance. Embedding these elements into the current framework would be a major undertaking and a cultural shift for the industry.

As for Pillar III, the Government in Uruguay regulates only the risk ratings of insurance companies; however, insurers are not required to have a rating to operate in the market. This is a long way from the reporting and disclosure requirements under Comframe.

The way forward in Uruguay

While the regulator in Uruguay is aware of the changes that Comframe involves, no major initiatives are expected in the near future. The size of the country and the limited number of players in the insurance market make it hard to imagine important advances taking place.

In spite of this, some companies that are affiliates of European insurers are considering Solvency II requirements to comply with the mandate of their parent companies. Other countries in Latin America are also pursuing an RBC framework that will evolve toward more sophisticated approaches to solvency assessment and risk measurement.

> One of the major challenges of implementing Pillar I in Uruguay will be the availability of talent and resources, especially for the valuation of reserves.

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