REINSURANCE - BRAZIL: TEMPTING FATE

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BRAZIL IS RANKED as the 10th largest economy in the world, with the 5th largest population and 5th largest land mass. Currently, its insurance market has a total premium income of $33.8bn (£17bn), which represents 41% of Latin America's total and is 20th in the world.

The government is actively promoting major development of Brazil's infrastructure and, in order to attract foreign investment after nearly 70 years, Brazil's reinsurance market is being opened up to international reinsurers. There is a huge potential for growth but international reinsurers, including those already active locally, may miss out on new opportunities if they do not actively engage with the new Brazilian regulators overseeing the changes.

The shape that Brazil's open reinsurance market will take remains uncertain. The regulators have indicated publicly that the drafting of the new regulations may be the subject of a wide consultation process but the extent of the proposed process is not known, and the concept of international consultation appears to have met with opposition from established local interests.

At this crucial moment of uncertainty and opportunity, it is important that international reinsurers take urgent steps to ensure that their views are heard and accommodated prior to finalisation of the new regulations, which are expected to be issued mid 2007.

Statutory Change

Observers of the Brazilian reinsurance market will know that its opening signifies a long-awaited change. Since 1939, the Brazilian Reinsurance Institute - the IRB - has been the monopolist reinsurer, retroceding all its risks to the international market and keeping a small margin of retention. These reforms will also bring about a radical change in the manner in which claims will be handled.

The new reinsurance law - Complementary Law Number 126 - revoking the IRB state monopoly granted by the old Decree Law 73, was unexpectedly enacted on 16 January. In summary, this marks the end of the IRB's ability to impose, unilaterally, settlement terms on the contracting parties by virtue of its dominant market position and its claims-control powers.

Under the CL, the IRB now becomes a 'local' reinsurer (defined in the CL as a reinsurer with its head office in Brazil) and will have to compete on an equal basis with all other local reinsurers authorised to operate in Brazil. Foreign reinsurers are to operate in the market either as local 'admitted' (with only a representative office in Brazil) or 'occasional' reinsurers (with no representative office in Brazil).

Local reinsurers have been granted a right of preference by the CL in order to protect the local market. In addition, at the time of placing risks through reinsurance, local cedents will have to offer local reinsurers certain percentages of their reinsurance placings - 60% during the first three years from 16 January 2007, and 40% after these first three years, indefinitely.

The CL also imposes some mandatory legal requirements for all reinsurance contracts. It expressly provides that in the event of a local cedent becoming insolvent, a reinsurer will remain liable to the liquidator (Article 13). It also provides for a statutory right of 'cut through' so that, in the case of a cedent's insolvency, the reinsurer's direct payment to the insured is permitted in every facultative reinsurance, or where an express cut-through clause is part of the contract (Article 14).

Informal announcements have been made by representatives of the Brazilian regulators, indicating a reluctance to over-regulate the new reinsurance market and to leave room for free negotiation between contracting parties - an established principle under Brazilian law.

While there is no certainty about the shape these new regulations will take, an educated guess can be made by reference to the now revoked regulations issued in 2000 (CNSP Res. No.01). These were challenged in the Brazilian courts as part of the failed attempt to privatise the IRB under a 1999 law.

Under these old regulations, admitted reinsurers were required to deposit an operational guarantee of a minimum of $5m in a bank in Brazil, and to have net assets of no less than $85m (abroad). Occasional reinsurers were required to have net assets of not less than $100m, with no bank deposit in Brazil required and local insurers could not cede more than 10% to occasional reinsurers for each year.

Furthermore, Lloyd's could apply for the status of an authorised admitted reinsurer, and Lloyd's member syndicates would have the option to operate within Lloyd's authorisation. It is not known if these financial requirements will be repeated or increased. Much will depend on whether the international market communicates its views to the Brazilian regulator before matters are finalised - and how successfully it does so.

Claims Adjustment

The CL is silent over who controls the claims adjustment process. Item I of Article 12 of the CL maintains a general power of the Brazilian regulators to intervene in the adjustment of losses by providing that they may require the "inclusion of mandatory clauses in reinsurance and retrocession contracts".

The CL does, however, revoke the IRB's statutory claims adjustment power. Therefore, all contracts of reinsurance should now expressly provide the basis for the adjustment of claims. Significantly, the CL is also silent as regards certain clauses that were previously stated as being mandatory by the IRB under the old Decree Law 73 regime. For example, 'follow the fortunes', claims co-operation (by inference claims control clauses were not accepted) and Brazilian jurisdiction clauses.

Therefore, subject to contrary provisions being issued in the future regulations, claims control and foreign jurisdiction or arbitration clauses may now become effective in reinsurance contracts under Brazilian law.

The CL's silence on this point may indicate an intention by the legislators that the parties' freedom of negotiation should be respected, or at least that this should be dealt with as a regulatory, rather than a statutory, issue.

Arbitration Clauses

In the past, there were conflicting decisions of the Brazilian courts on the validity of foreign jurisdiction clauses. However, after Brazil's ratification of the New York Arbitration Convention in 2002, foreign arbitration clauses have been consistently upheld by the Brazilian courts providing greater certainty to foreign parties.

The approach of the Brazilian courts has been based on the Brazilian Arbitration Act of 1996, under Article 3, which provides that parties may resolve their disputes by arbitration. The Brazilian courts have reinforced the principle that the parties may freely negotiate arbitration clauses in their contracts. Therefore, foreign reinsurers should be aware that foreign arbitration clauses are more likely to be accepted by the Brazilian courts than jurisdiction clauses.

Interim Regulations

Notwithstanding the CL, until new regulations are issued, the IRB remains sole reinsurer placing risks abroad. In fact, in spite of the recent legislative trend towards a more international and competitive market, the IRB re-issued its regulations in January, repeating the requirement of the insertion of its mandatory clauses - namely follow the fortunes, claims co-operation and Brazilian law and jurisdiction clauses - in all of the IRB's retrocession contracts.

This action, and its timing, surprised many observers, since the CL (still in Bill form at the time) was to require the new regulators to issue responsive regulations. Given that the CL expressly revokes the IRB's statutory power to issue any regulations, it is probable that once the CL was enacted - that is, after 16 January 2007 - the IRB's own January 2007 regulations in effect became invalid, or they are now internal regulations to be followed only by the IRB itself.

It may be speculated that the IRB's January 2007 regulations could influence the shape of the new regulations and the form of future reinsurance contracts. However, international reinsurers face a serious obstacle to business development should the new regulators simply adopt the IRB's mandatory clauses.

This would severely restrict the contracting parties' freedom of negotiation and perpetuate the previous anti-competitive market practices that have prevailed to date.

Although the new regulators have intimated that there may be a public consultation process, they have also suggested that the new regulations will be issued in mid 2007. Evidently, these two propositions do not sit comfortably together. It is, therefore, of critical importance that interested international reinsurers make submissions to the Brazilian regulators as a matter of urgency.

Increasing infrastructure development projects in Brazil are likely to generate greater demand for insurance in what has so far been a relatively underdeveloped local insurance market when compared with the size of its economy. This increased demand in insurance, coupled with the opening of the reinsurance market to foreign reinsurers, may create many business opportunities for international reinsurers that already have local representation and those interested in expanding their global operations.

The international market should be proactive in making its views heard and contributing to shape the new regime. The danger of waiting for the formal commencement of any consultation process is that such a date may never

come. The penalty for inaction may be that the international market's interests will not be taken into account and the opening process will be diluted.

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