

Regulatory diversification

Insurers pursue different
paths in Latin America



Building a better
working world



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Executive summary

Prospects for sustainable growth in Latin America have been on a downward slide in recent years. Some countries are on track for solid expansion, while others face economic challenges, including currency devaluations and evolving fiscal and monetary policies. Economic diversification and an expanding middle class will encourage increased trade and future investment.

The insurance market outlook is promising even though GDP growth across the region has slowed considerably, with most countries lowering their gross domestic product (GDP) forecast. As Brazil faces high inflation and one of its worst recessions, Argentina is slowly recovering. The four trading partners in the Pacific Alliance (Mexico, Chile, and particularly Colombia and Peru) are expanding at a solid pace.

The *2016 EY Latin America insurance outlook* summarizes the key issues facing insurance companies: increased competition and market consolidation, greater contagion risk and rising customer expectations. Against this backdrop is a complex regulatory landscape where companies are at various stages in advancing risk transparency and adopting global solvency standards, corporate governance and enterprise risk management (ERM).

We introduced our first Latin American report on regulatory developments in 2012, with an update in 2014. In the past two years, Mexico has set the standard by being the first in the region to adopt a framework modeled after Solvency II. Brazil received provisional Solvency II equivalence status in January 2016, and Chile is close on its heels with a risk-based capital approach modeled after Solvency II. Colombia is moving toward the more risk and economic value-based ComFrame, while Peru, Uruguay and Argentina have been cautiously watching their neighboring countries with no immediate plans to implement a risk-based capital system.

Risk-based capital and Solvency II-type rules are still evolving in many of these countries. Upgrading ERM practices and collaborating with governments, regulatory organizations and other financial institutions may be a reasonable strategy to achieve a more consistent insurance regulatory framework across the region.



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Argentina



Plentiful capacity in a crowded insurance market

Introduction

Argentina's economy is the third largest in Latin America, behind only Brazil and Mexico. High inflation, currency volatility, deteriorating consumer confidence and a slowdown in macroeconomic growth are only a few of the issues plaguing the country. The presidential election late in 2015 brought important political changes. Yet, while the new Government promises higher economic stability, analysts project that the 0.5% GDP growth will continue to contract. In spite of this outlook, the trend for the insurance industry is positive, driven by fresh inflows of capital and prospects for a return to consumer spending.

By global standards, the life insurance industry is underdeveloped, though a robust market for group policies is emerging that will foster continued growth and opportunity. Insurance penetration in Argentina is among the lowest of the major global economies. Both life and nonlife segments are expected to grow by 30%–40% in 2016, primarily due to inflation. Life, nonlife, retirement and workers' compensation are estimated to total US\$14.16 billion at year-end June 2016.

With more than 200 life and nonlife insurers, the market is ripe for consolidation. By 2002, nonlife is expected to outpace the life segment, which has been constrained by Argentina's ongoing financial crises and lingering effects of the 2008 nationalization of the private pension system.

"No risk-based capital or economic capital standards have been issued. However, market growth and consumer protection are high on the Superintendencia de Seguros de la Nación insurance agenda."

Gross written premium:

Life¹ = US\$2.42 billion

Gross written premium:

Nonlife¹ = US\$7.40 billion

Population size = 42.9 million

Regulation: potential to break from the past

The new Government aims to address reforms. However, risk-based capital is only one item on a long list of initiatives on the Superintendencia de Seguros de la Nación's (SSN) regulatory agenda. In 2012, the SSN defined the strategic plan for the insurance industry from 2012 to 2020, on the basis of projected economic growth and consumer recovery. It proposed to improve the regulatory environment and to focus on consumer rights and insurance industry growth.

While SSN proposed to reform the solvency system and to implement risk-based capital measures, nothing has changed relating to the local use of a risk-based capital model. The current solvency system follows traditional measurement methods that are applied consistently across all lines of insurance and coverage.

No risk-based capital or economic capital standards have been issued. However, market growth and consumer protection are high on the SSN insurance agenda. The growing life and pension insurance market in Argentina may benefit from ComFrame, though there are no immediate plans for implementation. It is unclear whether the SSN will create an internal body to assess the solvency of insurance companies. This measure was expected to be announced as part of the 2012 to 2020 strategic plan, but no further developments have been disclosed.

A more flexible investment environment

While there has been no news related to local use of a risk-based capital model or adoption of IFRS 9, there has been greater flexibility in investment regulations. Since 2012, the SSN had established certain minimums and maximums that insurers had to follow regarding investments in financial assets aimed at financing medium and short-term infrastructure projects.

In 2016, the new SSN authorities eliminated the regulations regarding minimum limits of insurers in small and medium enterprise projects. This new regulation has established only maximum limits (30% in profit and loss, life, retirement and reinsurance; and 20% in workers' compensation), except for investment funds in medium and short-term projects, where insurers are required to invest a minimum of 3% of total investments up to 20%.

Additionally, during 2016, the SSN eliminated some rules that insurers had to follow regarding investment and technical reserve currencies.

More recent regulatory developments

During the past two years, the SSN also approved a new insurance framework that centralized prior legislation. This was designed to tighten anti-fraud regulation, enhance consumer protection and make insurance agent registration compulsory. These measures should favor larger insurance providers who have the financial backing and resources to comply with this new framework.

A new regulation adopted in 2015 regarding anti-money laundering activities has established new formal requirements for insurers and brokers. Additionally, due to certain regulatory changes during 2015, insurers are now required to adopt a revised base for the calculation of premium deficiency reserves.

Moreover, due to some changes introduced by the SSN, workers' compensation insurers increased the level of lawsuit reserves in ARS4,000m, deferring the effect in profit and loss in 14 quarters. The workers' compensation system is immersed in high litigation as a consequence of an unconstitutional declaration in 2004. In June 2016, the Argentina Supreme Court declared in favor of the insurers regarding some index adjustments in monetary compensations. Additionally, a workers' compensation law modification is under review waiting to be sent to the National Congress for evaluation and approbation.

¹ This is estimated for 30 June 2016 based on nine months ending 30 March 2016, and excludes retirement and workers' compensation.

In March 2016, the SSN changed the criteria used to measure the property, plant and equipment (PPE) for insurers. The new regulation establishes that PPE are initially measured at their cost and, subsequently (after two years), measured using a revaluation model without impacting profit and loss, except for the depreciation expenses.

> The way forward

Argentina is one of the world's major economies, though insurance penetration remains low. This reflects the broader political and economic issues in the country, such as high inflation, fluctuating credit ratings, and the nation's large fiscal debt. These uncertainties impact how insurance companies do business and how potential foreign investors view the market.

The insurance industry in Argentina expects new changes from the SSN in the following areas:

- Increase in capital requirements, primarily for reinsurers
- More controls regarding technical losses, mainly in motor coverage
- Fiscal benefits for life and retirement coverage

The new Argentine President has the potential to reduce regulation and restrictions on foreign investment and introduce reforms which could lead to greater industry expansion. The SSN position on creating an internal body of insurance companies to assess their solvency was part of the original strategic plan. However, no further developments have emerged. Insurance companies are hopeful that growth, change and bolder reforms are on the way.



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Brazil

Provisional Solvency II equivalence encourages investment

Introduction

During the last 10 years, the Brazilian insurance market has continued to expand significantly, with an annual compound growth rate of 10%. This growth, coupled with the increased demand for insurance, has attracted the interest of the international insurance industry. In comparison with international markets, Brazil has one of the highest growth rates in insurance premiums worldwide: 12.1% between 2013 and 2014, and 10.2% between 2014 and 2015. Including premiums from health insurance, the annual growth rate was 16% between 2009 and 2013.

In addition, Brazil's market presents high growth potential for global and local insurers, as total premiums per capita and insurance penetration relative to the GDP are still low compared with developed countries.

"In the past two years, Superintendência de Seguros Privados has published significant regulatory changes aimed at moving toward Solvency II equivalence."

Gross written premium:Life² = US\$36.92 billion**Gross written premium:**Nonlife³ = US\$19.60 billion

Population size = 209 million

Emerging regulatory framework in Brazil

The Brazilian insurance regulatory agency, the Superintendência de Seguros Privados (SUSEP), has been seeking Solvency II equivalency. The European Commission granted provisional equivalence to Brazil – as well as Australia, Canada, Mexico and the US – for 10 years, effective 1 January 2016.

This equivalence is likely to facilitate European insurers investing in the Brazilian market, and Brazilians investing in the European insurance market. In 2015, SUSEP was accepted as a member of the International Association of Insurance Supervisors (IAIS). This was in recognition of the steps the country is taking in relation to the regulatory standards set by the association.

In the past two years, SUSEP has published significant regulatory changes aimed at moving toward Solvency II equivalence. The main changes are in ERM, market risk capital requirements and reporting, operational losses database (OLD), and internal model applications. The complexity of these changes and the demands on internal resources will challenge insurance companies.

ERM raises the bar on governance

In November 2015, SUSEP published Circular No. 521/2015, which modifies Circular No. 517/2015 and presents the deployment of an ERM structure as a primary goal. The risk management process comprises four basic steps: identification, assessment and measurement, treatment and control, and monitoring.

Risk management activities resulting from this regulation will have a strong impact on an insurer's business models and culture. Initially, this will require a very high commitment and determination by risk managers across the full range of their activities in order to manage risks and involve the board of directors in the process.

The circular also requires the appointment of an independent risk manager until December 2016, who will be accountable for continuously monitoring the risk management process. SUSEP requires each insurance company to engage the board in risk management activities, such as defining roles and responsibilities for areas directly involved with risks, defining and formalizing the company's risk appetite, and approving risk management policies.

In order to monitor and understand the risk management implementation process, SUSEP is considering distributing a questionnaire to all insurers. In addition, it is studying the possibility of applying "capital reduction factors" to insurers that fully meet ERM requirements. Regardless of the capital reduction factors, all insurers must meet the ERM requirements until December 2017.

The market risk capital requirement

In 2014, Conselho Nacional de Seguros Privados (CNSP) published Resolution No. 317/2014, which defines the market risk capital requirement as a combination of interest rate risk, equity risk, foreign exchange risk and commodity risk.

Besides the need to incorporate the market risk capital requirement in the solvency calculations, insurance companies must develop a methodological manual detailing all techniques, assumptions, procedures and materiality criteria adopted for their cash flow estimation.

SUSEP requires the following amounts for the market risk capital portion: 0% until November 2016, 50% from December 2016 to November 2017, and 100% beginning December 2017.

Eligible capital

SUSEP is also discussing new adjustments for eligible capital (own funds). It is considering the liability adequacy test, mark-to-market asset valuations and tax adjustments, so that differences in the accounting valuation of the same assets (held-to-maturity, held-for-trading or fair value) do not result in an incorrect calculation of the insurance company's solvency or risk-taking capacity.

These adjustments would require the participation of investment, actuarial, and tax departments in addition to accounting.

² This figure is for 2015, including the supplementary pension plan market

³ This figure is for 2015, not including the health insurance segment

The impact of OLD

Circular No. 492 of July 2014 addresses the constitution of an OLD for insurance companies, local reinsurance companies, open pension funds and capitalization companies. This regulatory norm establishes an operational losses reporting process to the regulatory agency, with the aim to generate a unified database for OLD, and the potential to recalibrate the operational risk capital requirement in the future.

There are two criteria defining the obligation for implementing the OLD:

- Technical provision amount equal to or above BRL\$200m
- Earned premium amount equal to or above BRL\$200m

SUSEP requires the deployment and first report to be disclosed by the insurance companies in August 2017.

Internal model application for health insurers

To ensure the service quality provided by health insurance operators, the Brazilian health regulatory agency, the National Regulatory Agency for Private Health Insurance and Plans (ANS), defined several principles, including risk management, internal controls and the possibility of applying an internal model for the calculation of regulatory capital. The regulatory norm No. 51/2015 implements criteria and guidelines that are necessary in order to adopt an internal model-based approach, replacing the standard formula for solvency margin calculation.

In addition, ANS defines the need to ensure internal controls and data quality. It also requests reporting mechanisms for the adopted risk management strategy, as well as embedding the internal model business decisions, governance, and operational processes. In order to adopt the internal model approach, the health insurer will need to provide a detailed explanation of the methodology and schedule for its implementation.



The way forward

It is expected that SUSEP will fully regulate Own Risk and Solvency Assessment (ORSA) in 2017, making it effective by 2019. This represents a major transformation on how insurance companies will operate, considering a forward-looking solvency assessment and business decisions tailored to risk-taking choices.

The process of full acknowledgement of equivalency for the Brazilian insurance market began in June 2015, with the approval of the first stage by the European Commission. This decision will most likely benefit Brazilian insurers planning to operate in the European markets, as it facilitates operations abroad. Similarly, European companies that operate in Brazil may benefit from lower capital requirements.

The first stage covered the solvency calculation for companies operating in the sector. The second includes an evaluation of potential group supervision, where several subsidiaries would be supervised as part of a group, and not individually, as before. The European Insurance and Operational Pension Authority (EIOPA) has already filed its report on this stage. In the last stage, the European supervisor will evaluate supervisory norms and procedures for the reinsurance sector.

In the case of full equivalency, the supervision carried out by SUSEP will be considered equivalent to the norms and procedures of the European market.



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“Knowing the operational losses in the organization enables preventive action. In an enterprise risk management context, the OLD may prevent significant impacts to the insurance companies and the market as a whole.”

– EY source

Chile

Progressing toward a risk-based capital regulatory model

Introduction

Chile remains one of the most stable markets in Latin America. The outlook for the insurance industry is promising and the potential for growth is being driven by evolving distribution channels, rising consumer expectations and emerging regulations. The country had the highest insurance penetration rates in the region until 2012. Since then, the insurance dynamics have changed and the pace of growth for both life and nonlife sectors has declined to under 2%. It may take a few years for growth to return.

The Chilean insurance industry is driven primarily by products that are mandatory by law and driven by the Superintendencia de Valores y Seguros (SVS), under the supervision of the Ministry of Finance. Life insurance, pensions and annuities account for nearly three-quarters of the overall market – making Chile one of the few countries in the region where life insurance has a larger presence than nonlife.

Gross written premium:

Life = US\$7.18 billion

Gross written premium:

Nonlife = US\$3.92 billion

Population size = 18.1 million

Emerging regulatory framework in Chile

With the regulatory landscape becoming more complex, the SVS has taken steps to develop to a more sophisticated risk-based capital (RBC) approach in Chile. An initial framework was introduced in 2012 (NCG 325 Risk Management, Pillar II) to protect the rights of policyholders, reduce the risk of insolvency and develop a model toward third country equivalence of Solvency II. This step was followed by further measures to detail methodology for the second Quantitative Impact Study (QIS2) in 2014. At that time, the SVS also presented other insurance regulation relating to consumer protection and market conduct.

In January 2015, the SVS issued a third draft on the framework for the RBC calculation. This document describes in detail the methodology for the third study (QIS3), reported in May 2015 to the SVS. This improved draft was based on QIS2 results and feedback from the insurance industry. The SVS plans to initiate future exercises in order to measure results and improve the model.

While the SVS is working to adopt RBC regulations equivalent to Solvency II, the results of the QIS studies have not been made public. Moreover, Congress has not yet passed legislation, though it is expected that the SVS will evolve into a Securities and Insurance Commission before that occurs. Insurance companies are still in a transition period – waiting for feedback on the third paper, which is expected to be implemented in 2017.

QIS3 – a step toward a more holistic RBC model

The methodology for calculating RBC in Chile continues to be refined. These changes in QIS3 show how the SVS is moving toward more global standards of governance, capital and risk transparency.

- A reduction (from 16% to 10%) of technical risk factors applicable to premiums and reserves for motor insurance
- Anti-cyclical adjustment to capital factors for risk calculation in stock markets
- Reduction of the capital factor from 40% to 20% for infrastructure investment funds, which is a new asset category to consider optimal hedging in exchange rates for market risk
- Addition of a credit risk capital requirement of 12% for asset categories (assets classified as other assets), including accounts receivable and prepaid commissions
- RBC adjustments for technical interest rate risk in mathematical reserves, where the use of a rate curve to discount probability flows is incorporated
- Other RBC adjustments due to longevity and market risk, with the Asset Sufficiency Test for pensions applied as a reduction of the technical interest rate curve

“One of the most significant issues for the industry relates to real estate and liabilities – two areas that will increase capital requirements for insurance companies.”

SVS proposes other regulatory measures

One of the most significant issues for the industry relates to real estate and liabilities – two areas that will increase capital requirements for insurance companies. One proposed step is a real estate risk factor review (currently 20%) or differentiation of factors according to real estate type. It is likely that insurers will consider implementing internal models to address this – and other – concerns.

In addition to RBC, the SVS is considering the development of other high-impact initiatives during the next fiscal year, including:

- New assessment in nonlife insurance to redefine capital factors of product lines other than motor
- Loss ratio stress review (currently 25%) of disability and survivorship insurance
- RBC review of longevity due to new mortality tables that will impact technical reserves for life annuities
- Reinvestment rate stress review in life annuities, considering correlation among the different points of the curve applied to the Assets Sufficiency Test and the application of a combined value at risk (VaR)

Also on the regulatory agenda is International Financial Reporting Standards (IFRS 4 and IFRS 9), which have mandated implementation dates of 1 January 2018. However, there are gaps that regulators have yet to resolve, particularly on issues relating to technical reserves and financial instruments.

“Solvency II in Chile is still pending approval. However, ORSA has already been approved and will be implemented next year.”

Insurers await ORSA approval

In October 2015, the SVS proposed to amend a norm that stipulates provisions for insurers' corporate governance and risk-management systems by implementing risk-based supervision and evaluating insurers' risk appetites. The proposed amendments also introduce ORSA for insurers' internal risk management.

ORSA will require insurers to conduct an annual self-assessment of their risk and solvency position, and prepare an annual report on future solvency and capital adequacy requirements in compliance with corporate governance structures. The report needs to be approved by the board of directors and submitted to the regulators within the prescribed time period.

In April 2015, the SVS also issued a regulation that established principles of corporate governance and enterprise risk management, improving and unifying the framework for capital and risk management. The principal changes related to ORSA are:

- Internal governance systems, focusing on the responsibility and performance of managers and their role as guarantors
- Financial return and insurer's self-defined risk appetite as a key business management tool over capital
- Business plans, profit and loss projections, and stress tests to establish the minimum solvency requirement

Companies need to consider these key issues for ORSA development:

- Integration: continuous feedback with the three-year strategic plan
- Risk appetite: consideration and balance of all risks the company will face
- Timeline: ORSA must be reviewed at least once per year, although it is presented as a continuous process that unites the company's strategic and operational activities

Corporate management must use the ORSA results continuously in activities such as capital optimization, risk transfer, policy pricing and risk mitigation management. The first self-assessment report was issued by the SVS in June 2016, and the second report, which comprises a quantitative evaluation, will be issued in September 2017.

> The way forward

ORSA represents a huge task for insurance companies. Insurers are starting to consider what this means in terms of the cost, resources and talent that they must allocate to this effort. ORSA does not require approval from Congress, unlike proposed regulation for capital requirements.

Solvency II in Chile is still pending approval. However, ORSA has already been approved and will be implemented next year. That would drastically change how companies view risk and require many insurers to establish a robust risk management structure and think more seriously about advancing risk transparency and capital management protocols.



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Colombia

Tightening capital market regulations

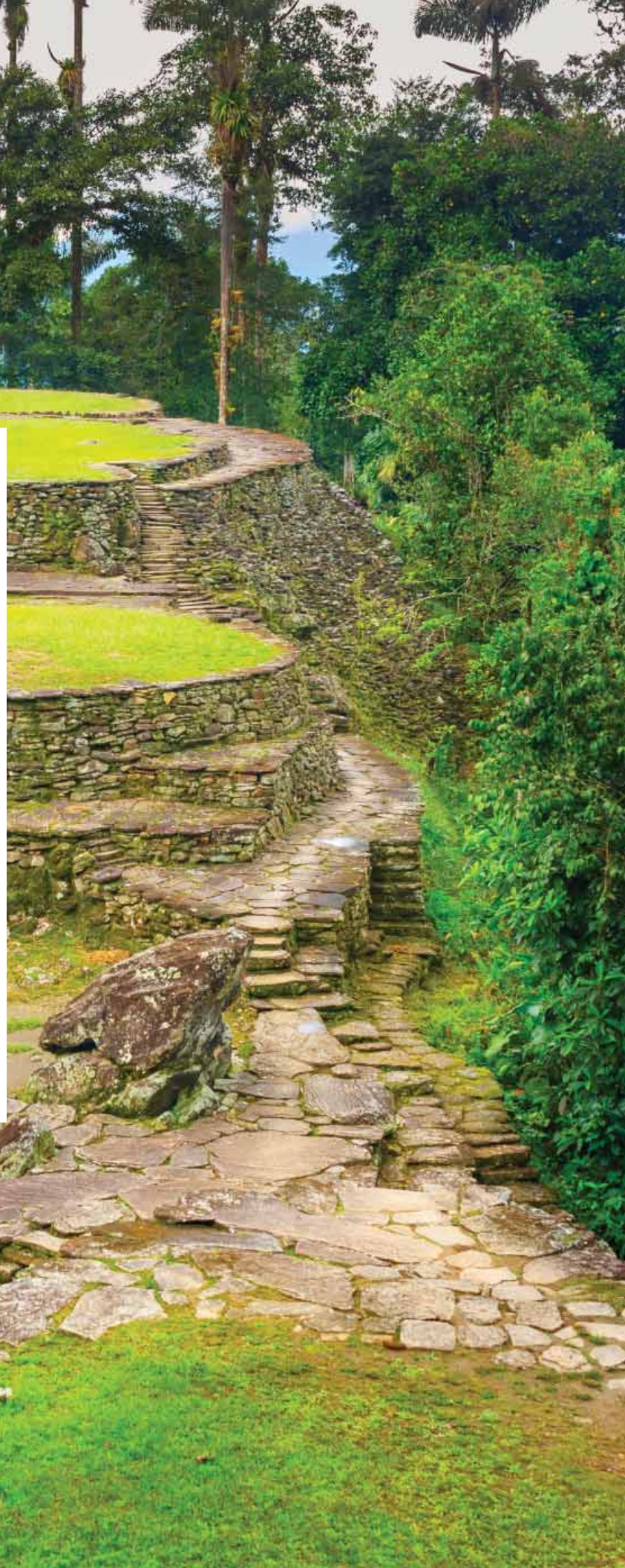
Introduction

Colombia continues to be one of the fastest growing countries in the region. Inflows of foreign investment and favorable trade agreements with other countries in Latin America have contributed to a stable macroeconomic environment. In spite of slower global economic growth and lower oil prices, the gross domestic product averaged about 3% in 2015 and, over the next four years, is expected to reach 4.4%. Unemployment reached a record low in 2015.

During 2015, insurance premiums were US\$7.16 billion, a nominal increase of 13% over the prior year. An upturn in life annuity sales was a major contributing factor. Real growth for the industry was 5.8%, or 1.9 times the growth of the economy.

Colombia currently has 26 nonlife and 19 life insurance companies. Insurance penetration was 2.7% of GDP in 2015. Low life insurance penetration is due to relatively low wages compared to premium levels. This has prevented individual products from becoming mass marketed, contributing to the perception of life insurance as an expensive investment.

Unlike other major Latin American markets, bancassurance is not predominant in Colombia - though it has been available for more than 10 years. While banks leverage existing customer relationships such as loans and mortgages, they do not offer insurance products aggressively. Customers tend to prefer the services of captive agents or brokers.



Gross written premium:

Life = US\$3.4 billion

Gross written premium:

Nonlife = US\$3.74 billion

Population size = 48.6 million

Current state of the market

New insurance laws implemented in 2013 liberalized the industry for foreign insurers, easing access and facilitating the establishment of branches in Colombia with the same rights and obligations as domestic insurance companies. This has encouraged the participation of foreign players and resulted in cost savings for multinationals, removing the need for local fronting businesses. Additionally, a weaker Peso is proving to be an enabler for M&A deals. Attractive growth rates and transparent regulations are other enablers which are pushing foreign insurers into Colombia through acquisitions and stand-alone ventures.

The government plans to invest an estimated USD15bn in civil infrastructure to develop or improve roads and highways, starting in 2016. This investment will be a key driver of growth for the overall economy – particularly commercial insurance lines such as engineering and property.

In addition to the threats posed by the current economic situation, the insurance industry faces significant challenges, most notably, negotiations with the government to resolve fraud in mandatory personal injury liability insurance and to increase insurance access for the underserved population.

Currently, financial and insurance knowledge is limited, and most products are mandatory. To achieve sustainable results and create a customer pull for insurance, a comprehensive customer education program will be required. Some efforts are already in place but more needs to be done. To become an insurer of the future and remain relevant for a growing digitally savvy customer segment, greater technology investments will be critical, particularly to overhaul legacy systems.

Adopting a digital strategy is high on the insurance agenda for many companies. Yet, despite the potential benefit of reducing distribution costs, little action has been taken. The fear of disrupting relationships with captive agent and broker channels is coupled with the significant investment required, especially for foreign players with small local operations.

Regulatory priorities and reforms

The insurance industry is supervised and regulated by the Superintendencia Financiera de Colombia (SFC). It functions under the Ministry of Finance, which has legal, administrative and financial autonomy. The SFC is instrumental in reforming the Colombian financial system and reviewing practices that impact investors, consumers and cross-border trade. In recent years, the regulatory agency and SFC have focused on updating regulations to modernize the industry, expand the insurance product portfolio, increase financial inclusion, and strengthen customer service and protection.

While not fully adopting Solvency II or ComFrame regimes, SFC is moving to tighten capital regulations with more risk-based and economic-value-based solvency measures. Other key SFC priorities are fraud prevention, ensuring fair treatment of customers, and implementing IFRS.

The timeline for adopting IFRS standards is divided into three groups:

- **Group 1** – Full IFRS standards in 2015: companies whose securities are publicly traded, defined as public interest entities, and large companies whose parent or subsidiary reports under IFRS
- **Group 2** – IFRS for SMEs standards in 2016: large and medium-sized companies excluded in Group 1
- **Group 3** – Normas de Información Financiera para Microempresas (NFIM) in 2015
- Additional published regulatory framework: companies supervised by the Contaduría General de la Nación (CGN – the General Accounting Office of the Nation) as of 1 January 2016

“The SFC aims to incorporate a risk-based capital approach into the current regulatory framework – without fully adopting Solvency II equivalence or ComFrame.”

What lies ahead in regulation for Colombia?

The SFC has made progress on a number of regulatory issues. Two in particular will be on the insurance agenda for 2016:

- **Premium sufficiency regulation:** The SFC has been working to ensure that insurance companies will pay their insureds' claims even in the worst-case scenario. New premium sufficiency regulation will require carriers to have sufficient reserves on hand to pay claims. Though the regulation is not yet in force, it is important to monitor the effect it will have on those companies that may not be in a position to respond to the requirements and will attempt to transfer the cost to their insureds. In the coming months, two legislative proposals will be presented: the first determines the information and parameters to be considered in calculating the mathematical reserve; the second defines the technical interest rate for estimating the mathematical reserve and the reserve for insufficient asset.
- **Customer insight (know your customer):** The SFC is advancing a project with the German Cooperation Agency and the Inter-American Development Bank to identify the barriers for inclusive insurance, assess the feasibility of amending the applicable regulations for these products, identify improvement opportunities and provide recommendations that promote a favorable environment for their development. As part of this strategy, the SFC issued legislation that simplifies the process of customer knowledge in insurance products. This proposal, which has been implemented in other countries without jeopardizing the control measures against the risk of money laundering and terrorist financing, is still in review.

“Though the SFC is not presently seeking Solvency II equivalence, it is moving toward adopting IFRS standards, particularly in the treatment of technical reserves.”



The way forward

The Colombian insurance industry presents great potential for 2016. Colombia enjoys a higher economic growth rate than other economies in the region and also foresees financial stability over the next three to five years, unlike some of its less fortunate neighbors. With high investments from international investors, supported by a growing middle class, Colombia presents significant growth opportunity in times to come.

Insurers are currently sitting on a wealth of customer data due to various regulatory requirements such as AML, but due to legacy systems and lack of system integration they are not using data analytics effectively. Such analytics will allow insurers to check fraud, improve underwriting and create cross-selling opportunities. They will need to invest in new distribution channels such as bancassurance, direct and digital to reach customer segments which are underserved.

Though the SFC is not presently seeking Solvency II equivalence, it is moving toward adopting IFRS standards, particularly in the treatment of technical reserves. Recent regulatory reforms are creating opportunities for insurance companies that dominate the growing and well-capitalized financial sector.



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Mexico

First Latin American country to adopt a Solvency II framework

Introduction

The Mexican insurance market is the second largest in Latin America. As of December 2015, gross premiums totaled approximately US\$22.5 billion, an increase of 7.3% over the prior year. The insurance penetration is one of the lowest in the region (almost 2.2% of GDP). Yet, the industry continues to grow against a backdrop of low inflation, declining unemployment and government consolidation measures.

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 41.7% in 2015, with a 6.8% increase in savings products.

The regulatory framework in Mexico is evolving toward a more sophisticated risk-based capital approach. A Solvency II regime was proposed 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), in the second half of 2008.

The Mexican Congress approved the new regulation in April 2013. QIS and Qualitative Impact Studies (EIC) are moving forward and new accounting principles are under discussion. Insurance companies are in various phases of implementation as legislation continues to evolve.

“In April 2015, after 730 days of implementation, the Solvency II-type insurance regime was introduced, making Mexico the first Latin American country to adopt the new framework.”

Gross written premium:
Life⁴ = US\$11.466 million

Gross written premium:
Nonlife⁴ = US\$13.03 million

Population size = 128.3 million

Current state of play in Mexico

In April 2015, after 730 days of implementation, the Solvency II-type insurance regime was introduced, making Mexico the first Latin American country to adopt the new framework. Governance system requirements are in place, except for ORSA, which is to be implemented in September 2016.

The regulator performed five QIS reviews; the comparative results from the qualitative impact study (EIC1 to EIC5) are shown in the following table:

	EIC 1	EIC 5
ERM	58.50%	71.80%
Internal control	54.90%	79.20%
Internal audit	63.10%	85.20%
Actuarial function	62.50%	80.80%
Board members and directors	67.30%	92.20%
Committees	46.90%	77.60%
Outsourcing requirements	55.70%	85.70%
Disclosure capabilities	57.80%	75.80%
Overall EIC	57.80%	79.80%

The risk management framework shown in the table is not yet in place. Insurance companies are struggling to include all the risks, especially underwriting risk, into the framework. For internal control, more robust frameworks are still being implemented.

For the QIS, the CNSF provided insurance companies with a software package to calculate the Mexican standard model for capital requirements. The software has been updated several times, leading to very different results – with the final version provided in the first quarter of 2016. CNSF's software package is highly sophisticated and enables insurers in Mexico to perform simulations that may not be required in other countries as a standard formula.

Benefits and challenges of implementing Pillar II

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

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

A report must be submitted to the regulator 120 working days after year-end. However, the report has been delayed; it must be submitted by the end of the third quarter of 2016 and reflect each insurer's progress on risk management activities. Since the Solvency Capital Requirement (SCR) software is difficult to use to project future capital needs, especially under stressed scenarios, insurance companies have been working on proxies to do the future solvency assessment.

“The experience in Mexico is very similar to that of EU countries where insurers are fulfilling requirements for an effective ERM system but still finding gaps.”

⁴ Fundacion Mapfre; APESEG; CNSF, year-end 2015



Other significant Pillar II activities include the following:

- 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 and the governance system at least once a year.
- The risk management framework must include risks set forth for calculating the SCR 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 first quarter results from 2016 (first official financial statements under Solvency II) will determine whether 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 use the standard model for the next two years while the new regulation is implemented.

Several insurance companies are preparing their self-assessment programs because they are unable to produce adequate results and are struggling with SCR and the new accounting framework. The volatility of own funds is a concern in the Mexican insurance market.



Other new accounting principles

CNSF formulated new accounting principles for first-time adoption in March 2016. The regulation differs significantly from IFRS. One of the topics under discussion is volatility in the balance sheet due to market valuations in investments and liabilities (no contractual service margin is included in accounting principles).

Another significant challenge is the implementation of the new accounting framework as it relates to information technology systems, particularly the income recognition for life insurance companies (premiums must be recognized considering the term of the policy, and for long term, income is recognized on a yearly basis).

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 that would be reflected on profit and loss (P&L) statements. However, the CNSF created a new account on the balance sheet in equity that is intended to absorb the effect of changes in discount rates. The initial impact in technical reserves (decreases) can be amortized over a 24-month period; the amortizations will go to the P&L monthly.



The way forward in Mexico

Most regulatory requirements are defined, and the methodologies to obtain the technical reserve balances are approved by the regulator. Therefore, it is important to analyze if the results are adequate based on the obligations of each insurance company and then implement these methodologies into more robust actuarial software.

In the case of the SCR, insurers are not expecting major changes in 2016, but there are still some areas, such as reinsurance and derivatives, that need to be reviewed.

The regulatory principles do not provide much guidance for ORSA, so each insurance company must define the level of maturity and reporting of this process, and evaluate the way the capital requirement will be projected.



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Peru

Regulatory change may be on the horizon

Introduction

The Peruvian GDP is estimated to grow 4% in 2016 – above the average for Latin America, according to the Central Reserve Bank of Peru. This outlook is expected to continue, promoting growth in the insurance market in 2016. Favorable macroeconomic indicators include an increasing middle class, declining unemployment, rising consumer spending and a positive climate for investment.

The insurance industry in Peru has shown steady development in recent years and profitability ratios remain highly competitive. Net insurance premiums increased more than 15% in 2015, with similar growth forecast for 2016 – far above the GDP rate. Premium growth has been driven mainly by annuities, followed by property and motor insurance. In 2015, general insurance comprised 39.5% of the market, followed by private pension system (PPS) insurance (26.6%), life insurance (21.2%) and accident and health insurance (12.6%).

The Peruvian insurance industry is composed of 19 companies – highlighted by new entrants to the market and an increasing investment of foreign capital insurers in recent years. However, there is still low market penetration (only 1.9% of GDP versus the Latin American average of 3.3%), and an even lower rate compared to developed countries.

According to Fitch Ratings, the insurance industry in Peru has historically been characterized by its high level of concentration in a few companies. In spite of strong competition, four insurance groups account for more than 70% of the market. As new companies enter, it is expected that their market share will gradually decline.

Gross written premium:

Life⁵ = US\$1.61 billion

Gross written premium:

Nonlife⁵ = US\$2.09 billion

Population size = 31.7 million

Current state of play in Peru

The Superintendencia de Banca, Seguros y AFP (SBS) is the supervisory authority for insurance regulation in Peru. It sets standards modeled on ComFrame parameters and is widely recognized for implementing measures based on what it considers appropriate for the Peruvian insurance market.

Therefore, it has been cautious to adopt an international regulatory framework, such as Solvency II or its equivalent. In some respects, the SBS is waiting for other Latin American countries to take the first steps. Mexico and Chile are moving toward Solvency II equivalency and setting a standard for the region. Insurance companies in Peru are benefiting from their experiences, while gaining a better understanding of the implementation issues and challenges that lie ahead.

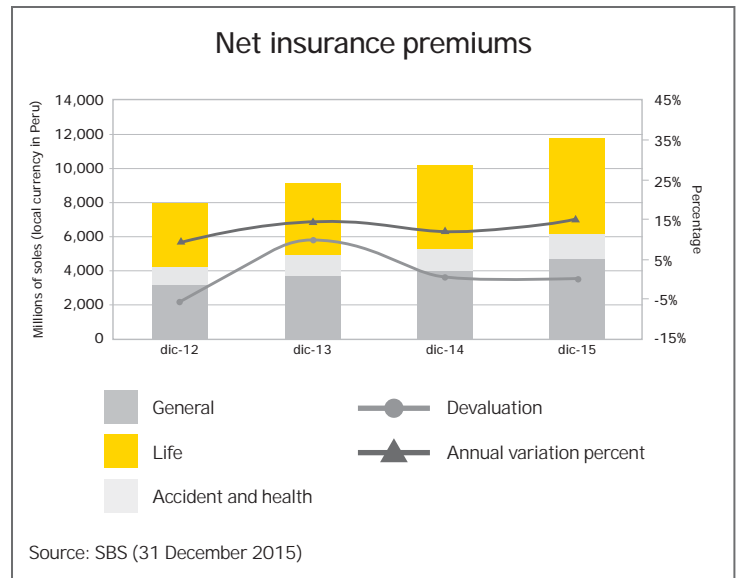
In recent years, the SBS has recommended changes in the regulatory framework of the insurance industry. These have been inspired by ComFrame parameters. However, ComFrame has not yet been implemented and the regulatory agency has set no specific time limit to do so.

“Mexico and Chile are moving toward Solvency II equivalency and setting a standard for the region. Insurance companies in Peru are benefiting from their experiences.”

IFRS 9 needs further review

As IFRS continues to evolve, many Latin American countries are finding the shift to the new insurance accounting standard to be a major transition. Peru implemented IFRS 4 in 2012, though the only provisions were for reinsurance; i.e., tables for technical reserves were established, with fixed rates published each month, which did not give companies the ability to establish their own rates.

IFRS 9 Financial Instruments, the final version released in 2014 to replace IAS 39 *Financial Instruments: Recognition and Measurement*, will be effective on or after 1 January 2018. Under Peruvian regulation, insurance accounting for financial instruments is similar to the IAS 39, with only a few exceptions. So far, the SBS has not addressed this issue, and it is not in their current agenda for review.



⁵Fundacion Mapfre, APESEG, CNSF year-end 2015.

Other SBS insurance regulation

The SBS continues to introduce insurance legislation around solvency, credit risks and technical risks. Resolution SBS No. 037-2008, "Reglamento de la Gestión Integral de Riesgos," defined comprehensive risk management as a process and proposed an ERM approach. This resolution has been modified since it was first introduced in 2008 as a standard for managing and defining risks and assigning responsibilities within a set structure. No major changes are expected in the coming year.

The growing trend of foreign insurers entering the Peruvian market is expected to continue as the SBS relaxes some of its regulation and creates a smoother investment environment. It now permits foreign companies to write reinsurance without prior registration as long as they have a minimum rating from a credit rating agency. Moreover, Peruvians may purchase insurance and reinsurance policies from foreign entities.

New tax legislation is also on the horizon that will reduce corporate income tax and raise the dividend tax rate. Peruvian life insurance companies are exempt from income tax where income is derived from assets linked to technical reserves for payment of retirement, disability and survivor pensions within the private pension fund administration system. This simplified taxation system will encourage future investment by foreign insurance and reinsurance companies.

However, there is also further debate about investment limits. New regulations make it harder to invest; for example, the limits for individuals and entities to invest in corporate, government, private bonds, equities and real estate are higher and more restricted due to additional requirements.

Lines of business are under review as well. Mortality tables for social security-related products were changed in 2010. Yet many life insurers do not have their own mortality tables and are operating with an adapted version of tables developed for the Chilean market. The SBS is currently performing studies for new mortality tables based on Peruvian experience.



The way forward in Peru

The political environment in Peru may change within the next year, with the election of a new President. In the meantime, no major regulation involving risk-based capital, Solvency II, IFRS 9 or ComFrame is expected. For the most part, Peruvian insurers are still following a Solvency I model and watching other Latin American countries such as Mexico and Chile before making decisions on their future direction.



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Uruguay

No major legislation toward a Solvency II approach

Introduction

Uruguay has a small, open economy that has contracted in recent years as a result of a downturn in the region, particularly in Brazil and Argentina, which are the country's key trading and investment partners. Economic growth is supported by agribusiness and services such as tourism, information technology, finance, transportation and construction.

According to Fitch's year-end 2015 ratings, the Uruguayan economy is stable and has strong creditworthiness. This stability, coupled with rising foreign investment and agricultural product exports, has encouraged a decline in the unemployment rate in recent years. Higher employment and more disposable income has increased the demand for life insurance as a savings product. Pension and retirement products continue to be among the fastest-growing life segments, as nearly 14% of the population are pensioners or above 65 years of age. In addition, 65% of the population is of working age, which is contributing to growth in individual whole life products.

Life insurance is concentrated with three major life companies, though nine conduct business in the country. Banco de Seguros del Estado, the state-owned insurance company, accounts for 63% of market share as of March 2016. Its dominance in the market has hampered growth in recent years. There are 15 companies in the insurance marketplace. Life insurance represents 37% of total premiums, and nonlife accounts for 63%. The nonlife insurance penetration rate is expected to grow at a CAGR of 11.9% between 2014 and 2019. Total GWP for the insurance industry is expected to increase from US\$375.4 million in 2014 to US\$954.0 million in 2019, after registering a forecast-period CAGR of 20.5%.

"It is hopeful that future regulatory reforms will make Uruguay a more attractive destination for international investment."



Gross written premium:

Life⁶ = US\$390 million

Gross written premium:

Nonlife⁶ = US\$776 million

Population size = 3.5 million

Current regulatory state in Uruguay

The Superintendence of Insurance and Reinsurance supervises and regulates the Uruguayan insurance industry and provides the regulatory framework to protect consumer interests. Industry standards are governed by national and global regulators, including the IAIS, which represents insurance regulators and supervisors in nearly 140 countries and provides guidelines to protect policyholders and contribute to global financial stability. The Superintendence is designed to promote domestic insurance and confirm that companies are financially stable. It establishes accounting and valuation standards, oversees the industry and evaluates solvency margins.

Guidelines for minimum capital requirements for insurance companies operating in the country are outlined in Circular No. 2087 on Standards Collection of Insurance and Reinsurance. The solvency margin for nonlife insurance is the higher of calculated amounts based on a premium-based or a claims-based method.

While other Latin American countries are pursuing a risk-based capital or Solvency II approach, Uruguay has not moved in that direction. No major initiatives are expected relating to these areas or to ComFrame. Capital is still calculated as a factor of premiums and claims, with no consideration for the risk factors that Comframe prescribes. Market growth and consumer protection are higher on the regulator's agenda.

Since 2015, the IFRS accounting framework in Uruguay has been determined primarily by company size. Small and medium-size enterprise (SME) IFRS applies to small entities (with some exemptions) and medium-size entities. Full IFRS has been applicable for open entities since 2012. Banks and insurance companies are regulated by the Uruguayan Central Bank. Banks are now in process of applying IFRS with some exceptions. It is likely that insurance companies will recognize IFRS as well, but is not clear when or how.

Changes in government legislation

Uruguay permits 100% foreign direct investment in its insurance industry. Foreign companies can establish operations and directly operate branch offices, as long as they are licensed to write life or nonlife business.

Overall, there have been no major changes in the last year in the insurance market. The primary change relates to cooperative government legislation that can go into effect after 1 July 2016. Changes in legislation include the following:

- All insurance companies must have a "corporate government," which is composed of company directors, principal managers, a new required actuarial function, and a new audit committee with internal and external representation.
- The corporate government will issue an annual report regarding the integral internal control system and risk management framework.
- Some of the external audit reports have been changed to align with this new legislation (tri-annual report will be issued regarding the correct implementation of the integral internal control and risk management systems).

With regard to income taxes, the top individual tax rate is 30%, while the top corporate tax rate is 25%. There is also a value-added tax (VAT) and a capital gains tax.



The way forward in Uruguay

As Mexico, Chile and Brazil move toward Solvency II equivalence, Uruguay remains uncommitted to a specific approach or framework. In spite of the limited size of the insurance market and the small population, the country continues to attract foreign investment. And, although there are fewer changes in regulation and legislation, there is talk of reform – and clearly a need to move in that direction.

While the insurance industry continues to evolve, capital markets are still underdeveloped and face considerable government debt. Implementing risk management practices and improving corporate governance will require resources and talent in the areas of financial reporting, underwriting and event-risk mitigation. It is hopeful that future regulatory reforms will make Uruguay a more attractive destination for international investment.



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⁶As of March 2016

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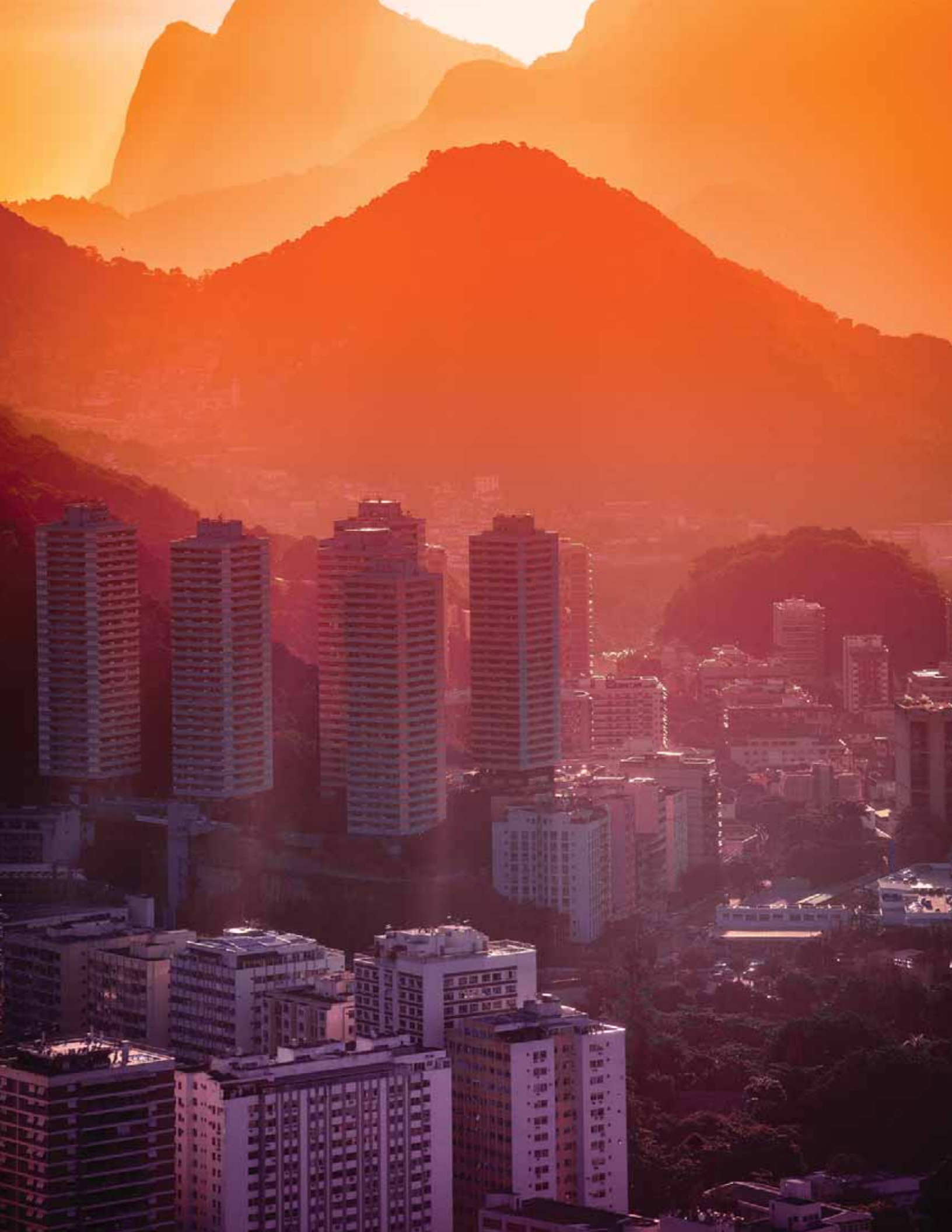
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