

# Surety Bonds: It is time to be competitive

## Introduction

Globalization is one of the most salient and powerful characteristics of our time. The rapid progress in transport and communication technologies and the governments' liberal policies have eliminated entry barriers in most of the markets, which requires that companies increasingly compete in the national and international arena.

Faced with this new scenario, any product or sector analysis requires a global outlook, and uncertainty is reduced by selecting a theoretical framework, models and tools to understand it and accompany its transformation.

This work is based on a common problem that affects all Latin American industries and insurers and poses a challenge and, at the same time, a solution for survival.

The effects of globalization multiply and are increasingly common. Surety bonds are losing ground as they cannot be tailored to the new requirements. The drop in global capacity at international level and product cannibalization due to excess of competition at local level show that the market, as we knew it from inception, is changing.

Regardless of the industry structure in each country, there is a supply and demand imbalance.

Due to changes in the environment in which we operate, a diagnosis of the current state of the industry should be made, and the dichotomy between the actual and desired position will show that the problem is more complex than we thought and that it is not limited to correcting deviations but would rather involve rethinking our vision and product strategy.

Market transformation is the Gordian knot to be cut on the supply side to profit from the benefits of a constantly growing demand. In this research paper, surety bonds are analyzed from a strategic, tactical and operational perspective. Recent events, such as the Brazilian government's plan to form a state-owned insurance company to meet the demand for capacity not covered by the private sector, the merger of Euler Hermes and Mapfre to defend their market share in Latin America, Swiss Re's decision to restructure their liabilities and reduce their long-term financial risk exposure and finally, the recent announcement of COFACE about the closing of their global surety line, implicitly pose the question: **"Are surety lines still profitable and attractive in an intensely competitive environment, with increasingly higher capital immobilization costs and greater investment return expectations"?**

Based on this question, the paper is organized in four stages: the first three, which focus on the adjustments to be made to reposition ourselves in a new environment, and the last one, to be ahead of the new requirements of a still transforming market. A new management model is derived from this process, which will be applied to the Argentine surety market to test its effectiveness.

## Current situation

Surety bonds originated as a number of contractual modes and as a derivative of a bank instrument in Great Britain in the 19th century. Liquidity problems in Europe, high interest rates and a sustained investment demand made surety bonds the product of choice since they allowed the optimization of loan facilities for production tasks.

They developed in closed, stable and independent markets, where the insurance companies' strategy was limited to meeting the demand, taking opportunities, expanding trade channels and cultivating the loyalty of clients.

As from the globalization process, companies became open systems in ongoing interaction with the market, which increased the direct and indirect competition and changed their environment. **It should be remarked that, in this new scenario, the companies' internal results depend to a large extent on the characteristics of the environment where they operate and on their ability to assimilate such environment and manage it efficiently.**

According to Michael Porter (1982), "The essence of formulating competitive strategy is relating a company to its environment." To understand how the environment influences the industry, I have combined traditional tools that enable knowing the strengths and weaknesses of the product, both on the local and the international markets.

The model of **five competitive forces, the life-cycle analysis** and the review of the industry's **critical processes** will help us analyze the operators' distribution of power, know the position within that structure and examine the importance of the environment as a catalyst for changes and requirements that modify market rules. Although they are tools of proven efficiency, they were conceived for stable environments and, therefore, I have adapted them to enlarge the perspective and avoid the error of placing them at the center of the environment, but rather in competition in a globalized market.

In this new scenario, surety bonds compete directly with other products that meet the same demand (substitutes) and indirectly in the reinsurance market for obtaining capacity to match the demand.

The problems related to the underwriting of big risks appear more frequently in Latin America. The commoditization of coverage due to lack of updating and product cannibalization as the only trade tool indicate that our industry, the environment and the forces operating in our sector are not in tune.

To maintain leadership, the strategy should be rethought and limitations overcome in order to develop a differentiating competitive advantage. Although the surety line is currently profitable, changes in the needs of surety bond holders and beneficiaries, new contract models, changes to the legal framework and restricted global capacity cannot be solved unless the companies consider a change of vision, strategies and management model.

## Surety bonds: the need for a mathematical method

Just as the market changes from a stable to a dynamic environment, the tools used to understand it should be renewed as they become ineffective. In this regard, during the growth stage, the **4 P's** model allowed the companies to capitalize on the opportunities of an expanding industry through a strategy that oriented their objectives and philosophy, from the supply viewpoint, around four variables: product, price, place and promotion.

Subsequently, market opening and increased competition led to the need for changing the theoretical framework by placing the client at the center of the strategy as a determining factor in both the demand and the product life cycle. The **4 C's** model allows companies to orient their resources in competitive environments around four principles: consumer, cost, communication and convenience. Both tools currently coexist as management models.

A comparative study of the automobile and surety lines will show the benefits and limitations of each of them:

- **Automobile line:** The client and the cost are the key variables of the strategy. The loss cost is the critical element on which all the other variables depend. It is calculated with a statistical tool that allows projecting historical behavior patterns and determining the underwriting breakeven point based on which the profit margin is fixed. It is estimated using a rational statistical accounting model with ongoing supply-demand interaction to analyze deviations. Underwriting and pricing are done simultaneously in one same process. This requires reviewing the price-cost relationship and operating above the breakeven point comparing from time to time the actual figures with the budgeted ones. As the rate depends on the total cost, resources optimization and process efficiency become the strategic objective in order to be competitive and profitable.
- **Surety line:** Unlike mass property lines, here the product and the price are the key variables. As surety bonds deviate from the mutuality principle and originated from a financial instrument, they do not fall within the typical statistical models of mass insurance. The surety line, unlike the automobile line, does not have an integrated underwriting and pricing model, and the process consists of two stages, one that is based on underwriting and the other, on experience. According to the method, the decisions taken are sequential, conditional and mixed. This approach allows evaluating only the underwriting process efficiency because the price is fixed on an independent basis.  
The lack of a procedure to establish an objective price, together with the commoditization of coverage, is the main weakness of the line.

The tactic used in surety bonds makes the product fall into an “**ambiguity trap**” when, in view of excess of competition, price war and low product differentiation, the price becomes the main tool for achieving business targets.

## The problem outline

The main globalization effect was the change in the industry structure from closed domestic markets to a global market. The integration of national economies through capital-flow exchange boosted the development of new options driven by brokers that compete for selecting those alternatives that maximize the investor's return.

As a result of this restructuring, globalization creates opportunities for anyone who is able to adapt to the challenges it poses. As in any instrument that operates and competes in a global market, the strategy, theoretical framework and tools of surety bonds should be tailored to reduce uncertainty and include disciplines that provide key information for decision-making.

Problem diagnosis, made through the structural analysis of the "five forces" and their key processes, identified the loss of competitiveness in relation to other options due to the industry's failure to provide tailored products in response to market-driven evolution and transformation.

This is a conceptual limitation and conditions the way we analyze the problem. We are currently using tactics that make the strategy fail. The mismatch between the return on investment and the risk assumed by reinsurers for the capacity they make available to the companies is an equation difficult to solve within the traditional theoretical framework. Likewise, the management model focused on the product-price relationship under similar contractual conditions places the line in a "vicious circle" that increases the problem.

We cannot just mimic the competitors' advantages, nor is it enough to know the structure, explain the results a posteriori and retrospectively understand the sector evolution. The changes that are being brought about in the global environment require not just process reengineering; no product is immune to falling into inertia, routine and shortsightedness. In this regard, I hold that any industry needs to be in tune with the present and project a future vision.

### A three-stage process

Based on the five forces framework, I developed a three-stage process to reposition the surety line in a new global environment:

- I. **Competitiveness:** Surety bonds are analyzed from the new vision of a global market investor. The product is taken as an alternative by applying the decision-making process and the selection criterion based on the "return-risk" relationship. This relationship is then used to evaluate the product by incorporating it into the global product strategy.
- II. **Profitability:** In view of these new requirements and demands, competitiveness and attractiveness are expected to be maintained through a method that ensures objective decisions and a resources optimization and process efficiency tactic.
- III. **The future market:** By taking globalization as the cause for market transformation, the impact of the implementation of the new legal framework and its effect on the industry structure will be analyzed.

#### I. Competitiveness

The term *competitiveness* began to be used in globalization-related matters to talk about how the US industry was losing ground to the European industry in the 1970's. The process affected all sectors and changed the companies' competitive environment; as the supply grew, they had to fight to maintain their market share. Changes in the environment turned closed and stable scenarios into dynamic and open ones. The market share, a parameter used to measure the strategy, was replaced by competitiveness.

Based on this process, deviations can be classified into two groups. The first consists of special capacities required by big infrastructure projects, which cannot be solved due to the combined effect of the reinsurer's cost of immobilization of resources and the high risk associated with the project. The second group is formed by the increasing number of operators in each country and

risk aggregation that puts pressure on automatic treaties, which exceeds the reinsurer's increasingly limited availability of resources.

In this section, the capacity problem is analyzed from the perspective of the investor who, by providing funds, allows reinsurers to have the required liquidity to finance the companies. The investor should choose from a wide range of options offered by the market and decide what proportion of capital will be allocated to each one to obtain the highest possible return through the evaluation of their behavior over time and the implementation of suitable changes to maintain an efficient portfolio.

As theoretical framework, I have used the **Portfolio Theory**, which explains how the decision-maker assesses each alternative based on the instrument's risk and expected return. This theory is very useful for surety bonds because it analyzes the reinsurers' financial behavior when they decide to redistribute their resources and allocate capacity to those lines that require less immobilization of capital and have a low risk and higher returns. The theory is limited to the application of an economic principle that describes the selection based on two inversely proportional variables:

- **Return:** It is the capital efficiency parameter and entails deriving a benefit from the minimum possible resource.
- **Risk:** It considers the probability that the investment return is not obtained; the reinsurer should take into account the losses due to the underwriting process inefficiencies (prevention) and the subsequent claims handling.

To solve the capacity problem, it is necessary to be competitive by generating a return on investment higher than the market average (**opportunity cost**). So, competitiveness, profitability and risk are concepts that should be added to the strategy. The challenge of improving productivity in the "reinsurer-company" relationship is to develop a "risk management" system that uses the same parameters as the financial market (solvency, liquidity and profitability) to match any investment alternative.

## II. Profitability

In the current business scenario, the companies' key objectives come down to two fundamental principles:

- Strengthening and increasing the competitiveness of their products.
- **Strengthening and increasing business profitability.**

In this section, the deviations in the "company-client" relationship caused by globalization are analyzed from the profitability viewpoint. Ongoing changes at global level continuously modify the competitive environment of surety bonds. The "product-price" strategy, typical of growing markets where the demand exceeded the supply and management focused on production and relied on the assumption that "the companies know what is good for the client," was replaced by a new scenario with mature products that must compete for a higher market share and requires a strategy focused on the "client-cost" relationship.

The focus on production in dynamic environments, as in surety bonds, results in the shortsightedness of defining the business in terms of the product without taking into account the benefits sought by the client; therefore the signs of change in the industry cannot be explained or expected. In this scenario, the client is placed at the center of the strategy. In competitive environments this requires abandoning the price concept and adopting the effective cost one, which involves adopting a production paradigm aimed at differentiation based on process efficiency and resources.

The new industry and environment structure requires being competitive and profitable, and being strategically and tactically consistent to comply with the **"risk-return"** principle.

“Strategic cost management” is a discipline that has recently emerged as a management tool, similar to the one applied in the automobile industry, but with a comprehensive approach including resources, processes and positioning.

The key variables are:

- **Grossing up:** It is the method used to determine the price based on total costs. Thus, the more efficient the company is, the higher the profit margin will result.
- **Segmentation:** Abandoning the focus on production requires segmenting the portfolio and generating information to identify the most profitable product mix.
- **Loss assessment method:** The actual cost of each cover will be estimated by combining the benefits of segmentation and different valuation methods.
- **Cutoff rate:** The process helps ensure a profit margin calculated based on a minimum efficient cost for each business line. It will allow reinsurers to safely calculate the return on investment based on the capacity offered.

In the **Annexes**, these concepts will be developed with actual figures (2006-2010) from representative operators of the Argentine market. A comparison will be made of the methods, deviations and limitations involved in operating with a single-rate system (focus on production) versus segmented rates based on each cover (efficient cost).

### III. The future market

Over the last decades, the insurance industry has been affected by the globalization process. The changes made will not only continue, but will also be strengthened in the medium and short terms. In this section the “scenario-company” relationship is examined in relation to the changes that may reshape the industry structure. The “five forces” model allows identifying the causality relationship of the environment as a key factor of positioning, structure and the life cycle of surety bonds.

The globalization of big insurance operators and their growing convergence with other sectors, especially the banks, pose new challenges due to higher integration in the global financial environment, the occurrence of similar risks and the multiplication of clients that seek global solutions to their international problems.

This trend has raised concerns about meeting not only present needs, but also analyzing in advance the impact of future changes on the companies operating in Latin America with differing strategies but with increasingly shared problems.

Globalization occurs not only in the industry, but also in the industry’s regulatory agencies whose resolutions currently focus on two key issues: (i) the adoption of IFRS2 accounting standards, which are closely related to the way they communicate with the financial markets, and (ii) Solvency II, which requires an integrated risk management system.

Both Basel and Solvency II aim to set a common standard for the valuation and management of global market instruments to allow for a consistent comparison of the alternatives the investor is offered by the market.

For surety bonds, the challenge of adapting to a new business management model will be even greater, because they are financial instruments that operate as insurance from the legal standpoint. Any major change to the legal framework will create opportunities and threats, winners and losers.

Under Solvency II, a financial penalty will be imposed for errors in strategy and tactic, so it is of outmost importance to analyze whether the management model needs to be updated for this scenario. Summarized below are the key aspects of the standard and its effects on surety bonds.

- **Solvency:** The impact on capital cost will determine the companies’ competitiveness in the industry; all decisions will affect their “capital.” Cannibalization tactics and the lack of an information system for big risks will increase the capacity problem by affecting the flow of investment and losing ground to new, more efficient alternatives.
- **Process:** To ensure the investor its capital will be protected, resources efficiency and process effectiveness standards are used to reduce the operational risk.

**Solvency II** will reshape the market structure through new requirements (capital, risk and return), and a change of business management methods will be essential.

## Conclusions

Surety bonds are subject to continuous changes. The ability to identify risk and find solutions for all the users' benefit is a precondition for keeping up with the market. Currently, the market, as it was known from inception, is in the midst of a transformation process as a result of globalization effects.

The integration of securities, exchange and debt markets gave rise to a global financial market which diversified options and increased the pressure for obtaining higher returns as a differentiating criterion.

This paper shows that the lack of capacity in Latin America is due to the imbalance in the “**risk-return**” relationship of reinsurance treaties. This makes our alternative lose ground to a more demanding and selective investor. Likewise, product cannibalization naturally appears as a tactic in view of the industry's maturity and the operators' degree of rivalry.

The gap between the actual and desired positioning requires rethinking the strategy, the tactic and the theoretical framework currently used due to the failure to explain, foresee and solve the problem.

Basically, the strategy is no longer focused on the supply but on the client. This calls for a change of management models and the adoption of new production principles.

The globalization process creates opportunities only for those operators who are able to adapt to its changes and poses a threat to those who fall behind. The parameters to evaluate the positioning have also been changed in order to monitor changes in the structure and environment; terms like *competitiveness*, *attractiveness* and *profitability* have been included as strategic management indexes.

Since this is an ongoing and dynamic process, the solutions to the problems found are just partial adjustments to be made not to lose competitiveness in relation to other options.

### In this new scenario:

- Only efficient companies will be able to differentiate from others and survive. The surety industry should rethink its business approach, tailoring its product to the new client needs, keeping pace with legal changes through innovation and reengineering of coverage to be effectively positioned in the new scenario.
- The requirements the **market** imposes on companies entail abandoning a management model and product concept they have had from inception. It has been shown that one has to be in tune with the environment.

**“One should not adapt to change, but create it.”**

**Jorge González Moore**



## References

- Aaker, D. *El éxito de tu producto está en la marca*, Prentice Hall.
- Agata, H. and Rodríguez, J. *Solvencia II, un proyecto complejo pero con principios sólidos*, Gen Re México.
- Gil Lafuente, J. *Marketing para el nuevo milenio*, Pirámide, 1997.
- González, S. *La globalización de los mercados financieros*, Universidad Complutense de Madrid, 1999.
- Hamel, G. and Prahalad, C. *Estrategia crucial para crear los mercados del mañana*, Editorial Ariel, 1998.
- Holden, R. and Nagle, T. *Estrategia y Tácticas para la fijación de precios*, Barcelona, Granica, 1998.
- Kotler, P. *Dirección de mercadotecnia*, Prentice Hall Hispanoamericana.
- Kotler, P. *Marketing Management – The Millenium Edition*, Prentice Hall, 2000.
- Newell, F. *Las nuevas reglas del marketing*, Mexico, McGraw-Hill, 1997.
- Orellana, S. *El capital asset pricing model: CAPM, historia y fundamentos*, trabajo de investigación, 2004.
- Shank, J. y Govindarajan, V. *Strategic Cost Management*, Free Press, 1993.

## Annexes

In this section we will respond to the question this paper is based on: **“Are surety lines still profitable and attractive in an intensely competitive environment, with increasingly higher capital immobilization costs and greater investment return expectations?”**

Although it can be said that Latin America continues to be an attractive market for sureties, brokers and reinsurers, signs of drying up pose the need for reconsideration of the current status and the future outlook of the line.

As mentioned in the **Introduction**, the symptoms of change in the environment appear when the big players face difficulties to provide coverage for projects that, due to their magnitude, call for risk aggregation in one policyholder.

A historical review of this type of operations shows that in the 1980's and 1990's the Latin American region had a different organization and structure. Some countries' competitiveness was so low due to the lack of investments in infrastructure that they entrusted most of their resources to multinational companies with experience and solvency in this kind of operation. In addition, these countries encouraged the setting up of international insurers and brokers to provide services to their integral clients, whose demands for coverage of big risks were solved through “global programs.” These programs were simultaneously and directly negotiated by the headquarters' office, the broker and the reinsurers through the allocation of special capacities or the creation of captive reinsurers.

As a result of the joint negotiation between the insurance broker and the insurance company, competition no longer existed. At the same time, the rate was a reference parameter for the local market. Global capacity for each project was allocated a rate that took into account the client's total cost, the broker's commission and the return on investment expected by the reinsurer.

The medium-term investment policies adopted by each country encouraged the setting up of Latin American transnational companies, local capital companies, which benefited from public works policies and expanded to become direct competitors of the international companies.

Public investment became the engine of economic growth. It indirectly boosted surety bond development throughout the region thanks to the demand for traditional works guarantees and coverage of customs duties on capital goods.

Unlike the global programs, the special demands of the transnational companies were established by free interaction among operators, which boosted price competition; the global market capacity was divided and commissions rose to attract the brokers who managed these accounts.

This explains the gap between local and international rates, and the current troubles to obtain capacity for special risks. The medium- and long-term economic plans will not be supported by a traditional model which has not been adapted to the new demands of the international market and the local clients' needs.

As a research of the whole Latin American market was impossible to do because of the differences inherent to each sector, I selected a representative sample. This is an advantage since the number of assumptions has been reduced to eliminate differences and get similar results to those which would be obtained from an analysis of the whole region.

Though this line growth had different penetration rates for each country, it exhibited a similar behavior. The line grew following the trend of the economic cycles under general homogeneous conditions as to the object and type of cover. Slight variations in the “loss configuration” were found; the conclusions to be derived are neither limited nor conditioned.

### **Surety bonds in Argentina**

The Argentine surety industry was selected for this work because it is a traditional sector that is taken as a model in Latin America. It has more than fifty years' experience and is an innovator in the use of trade channels and covers. The first records date back to the 1960's. Amendments to the Law on Insurance incorporated this line to the regulatory framework through a decree which

allowed insurers to underwrite surety bonds, which were technically and economically managed as insurance operations.

The surety bond has become the most widely used product thanks to its flexibility, effectiveness, versatility and service for both public and private beneficiaries. It is also a management and control tool for foreign trade operations as from the implementation of the electronic underwriting, transfer and management system of customs guarantees, and is also useful for auditing reinsurance treaties.

For all these reasons, Argentina's surety industry becomes a representative case study.

In most Latin American countries the growth rate has slowed down driven by the sector cannibalization as a result of an excess of supply, the impossibility of meeting the demand for big risks and the development of substitutes which make up for the lack of capacity or product inadequacy.

The strategy used by five representative operators, the leader and four followers (two monoliners and two multiliners, in the 2006-2010 period) will be analyzed following the four-step process which is briefly explained below (they will be examined in more detail further on).

- I. **Analysis of the five competitive forces + life cycle:** It seeks to define the environment using tools adapted to the new scenario, the distribution of the industry forces and the local and global positioning of the product.
- II. **Competitiveness analysis:** Based on the product weaknesses as a global financial instrument, the investor's decision criterion is analyzed as to capacity efficiency and its return.
- III. **Profitability analysis:** The effectiveness of the management model may be proved through two scenarios, the current one and the one suggested, based on the competitiveness requirements set by the global market and the reinsurer's decision criterion, which is conditioned by the sector structure.
- IV. **Competing for the future surety market:** Finally, the new requirements of the environment on regulatory matters (**Solvency II**) and the future impact on the industry structure, as compared to the current positioning and future demands, are analyzed.

#### **I. Analysis of the five competitive forces + life cycle**

The markets and the competition are changing, and the insurers, to a greater or lesser extent, are suffering or fighting. In any circumstance, we wonder which the suitable strategic framework is and which changes are to be made. It is known that strategies do not equally work in all environments, so it is necessary to know the situation that the market or a company is going through.

A company's organizational dynamics, the pace and the way in which the environment moves should be taken into account when devising action plans to continue to be competitive in a globalized world.

The classic positioning strategies within stable environments, with competitive advantages based on cost leadership or differentiation, with closely linked resources and long-term relations, are giving place to new strengthening and opportunity strategies typical of dynamic environments.

The current system cannot explain nor foresee the signs of change in the industry. The strategies were created for stable, closed scenarios, with known needs and shortage of supply, and their target is to take advantage of the demand growth rate.

To examine the situation of the selected market, I decided to use the «five competitive forces» model, placing the client at the center and expanding the product limits to include not only the substitutes, which are direct competitors, but also other instruments with which we compete for financial resources.

Graph 1 (at the end of the Annexes section) helps us understand that lifting entry and exit barriers is not enough to reduce the penetration of substitutes; we should also maintain our positioning in relation to the reinsurer.

#### **Changes to the approach:**

- **Insufficient range of capacity:** This problem is clearly shown by the larger number of substitutes which directly affect surety bonds.
- **Industry contraction/expansion:** The product cannibalization tactic slows down growth. The purpose is the creation of a strategy to increase growth potential through the reduction of substitutes, penetration of undeveloped economic sectors or the creation of new products (innovation).

The advantage of this type of graphs is the easy visualization of the globalization effects and the importance of the environment, which allows us to identify strategies affecting the market and its operators.

All the elements are correlated and interdependent.

**Surety market:** Argentina

**Regulatory agency:** National Superintendence of Insurance

**Type of market:** perfect competition

**Number of players:** 61 companies

**Leader:** monoliner (shareholder: Common investment fund)

**2010 market share leader:** 15.91%

**Global automatic capacity:** USD 600 million (rate of exchange: ARG 4.35/USD 1)

**2010 annual premiums:** USD 138 million (rate of exchange: ARG 4.35 / USD 1)

**Concentration among the top 10:** 75.84%

**Annual growth rate:** 20%

**Average cession rate:** 51.29%

To understand the industry structure in view of this new scenario, I decided to break it down into two variables:

1. **Structure:** I will use the “five forces” tool, the life cycle of the product and the critical process analysis which are suitable for describing the current status of the sector.
2. **Environment:** I will give a brief explanation of the core amendments to the legal framework and their impact on the product stressing their influence on the structure.

**Structure:** Since its inception, the industry has gone through different stages. It began with the “introduction” of a few local capital companies which took advantage of the mandatory demands of the public sector encouraged by low minimum capital requirements and deficient control. After that, the industry went through a growth stage where each insurer tried to differentiate from the others in how they conceived and offered the product. Thus, there appeared two management models: an integral one and a departmental one. The market was growing due to both expansion and penetration, new covers appeared and the percentage of profits was higher than those of the other lines. This encouraged the entry of operators who, with segment strategies and trade channel covers, positioned the product as a more accessible alternative to guarantee this type of operations.

With time, the growth rate began to slow down and an optimal market share was achieved, with client loyalty and lower but stable marginal contribution. The operators currently intensify their fight for market share by reducing their growth and profitability even more. There follows a summary of the distribution of forces:

- **New competitors:** The current “minimum capital requirements” combined with lower profits are the main entry barrier in view of the extension of the investment recovery term.
- **Substitutes:** In the last decade, the reciprocal guarantee companies and the trust agreements have displaced surety bonds as the exclusive guarantees for private works due to the lack of updating for the coverage of new obligations and product development.
- **High price trap:** The main problem the industry is going through is to be trapped between two opposing forces. On the one hand, the brokers who compete for price and commissions to seduce clients and companies, respectively, and on the other, reinsurers, whose capacities have a lower profitability than the capital immobilization cost, and higher risk.

**Environment:** With the “five competitive forces” model, this variable was identified as the factor responsible for the most significant changes which are hitting the sector. The governments’ regulatory agencies understand the international market demands at a faster pace than the companies themselves, and force them to adjust their processes. After the convertibility crisis, and in view of the financial market weakness, the government tried to shield the banking and insurance systems through new regulations to mainly protect the “consumer” and their social role in the economy. So, the market was actively regulated under solvency rules. The target will continue to be the technical match between the results of the underwriting policy and the minimum capital requirements.

- **Resolution 32080 (2007), Rate regime:** To stop the price war in the automobile line, the SSN<sup>1</sup> fixed a standard: the rates should be higher than the underwriting breakeven point with a maximum deviation of 5%. Losses should be offset by capital contributions and rate adjustments. The companies are obliged to obtain underwriting profitability in all lines, so they are indirectly requested to efficiently manage their resources in order that their prices remain competitive.
- **Resolution 35493 (2011), Big risks:** New requirements for underwriting risks exceeding USD 10 million were set; these include a mandatory net equity of USD 5 million, regardless of their reinsurance structure. This regulation specially affects monoliners with low net equity that cannot take advantage of their capacities when the risks exceed this limit.
- **Resolution 35615 (2011), Reinsurance Regime:** To regulate these operations and improve liquidity in the payment of losses, reinsurers are requested to set up local subsidiaries or branches. This reduces the supply because new minimum capital requirements (USD 20 million) and higher minimum reserve requirements are fixed, and the companies are submitted to government control.

The revision of the legal framework, together with the different tools, makes it possible to determine the positioning, strengths and weaknesses, identify problems and know the deviation between the actual and projected figures. The analysis of the environment contributes to revising the strategy, while the structure analysis provides information about the tactic employed.

From the strategic standpoint, the big risks segment is being lost due to a competitiveness issue. At local level, the distribution of forces stimulates competition, i.e., the price war as a tactic to maintain the market share. New regulations modify the investment evaluation, both as to the necessary capital and the investment recovery and profitability.

The environment continues to modify the sector structure through regulations which change the operation and management rules. The rates are the “tip of the iceberg” of a new management model imposed by the government to protect the industry. The impact of underwriting reserves mainly affected monoliners, which had to revise their processes, costs and commissions to maintain competitive prices. The Argentine market is in the midst of a transformation process, with partial financial and legal changes.

## II. Competitiveness analysis

The industry structure proposed by Porter’s model shows that the Argentine market is currently in a “**high price trap.**” This situation appears when a company is in the middle of two forces with high negotiation power and opposed targets. Brokers compete to gain clients using low prices as a trade tool and demand, in return, a rise in their commission. This tactic reduces the sector attractiveness in the medium term due to the decline in the profit margin caused by the combined effect.

On the other hand, to expand the capacities requested by the companies, the reinsurers evaluate each request in relation to the period they have to maintain their reserves, the return on investment and the portfolio risk. As per this analysis, while the brokers fix a low price to compete, reinsurers demand higher profit margins to offset the capital immobilization cost.

The tools used help us identify the key variables of the loss of competitiveness through the relationships **environment-reinsurer** and **environment-company**, which are shown by the following equation:

---

<sup>1</sup> SSN: National Superintendence of Insurance of Argentina, regulatory agency of insurance companies.

$$\uparrow \text{Commission} \downarrow \text{Price} = \text{Company} = \uparrow \text{Profitability} \downarrow \text{Risk}$$

Here the environment is studied as a change factor and its degree of influence on reinsurance and the companies is analyzed. From this perspective, we will try to explain the reasons for the market limitation to expand its global capacity. Such limitation contributes to a further slowdown in the industry and accelerates its transition to maturity.

In the 1990's, because of globalization, the local markets turned into a single global financial market. This modified the investor's decision-making process because it increased the options available to the investor.

The industry continues to evolve and transform due to factors that alter its architecture, such as deregulation, disintermediation, financial innovation, development and globalization.

The surety bonds are lagging behind new options, mainly because the changes that are taking place at global level and in the decisions of the investors who are operating in a globalized environment have not been understood.

To understand the capacity problems it is necessary:

- To identify the reasons for the loss of competitiveness in the global financial scenario.
- To determine the reinsurers' demands and understand their decision-making process.

The capacity issue may be explained on the basis of the economic principle "**risk-profitability**," which sets out that someone who wishes to obtain big profits will have to take the risk of suffering big losses. Investors are not indifferent to risk, they demand a compensation to take it. In this sense, the market has become efficient in qualifying each alternative in relation to these two variables, which allows comparing them and creating a preference scale.

Similar capacity issues throughout Latin America make it possible to extrapolate this market study and its conclusions to the whole region. ***Capacity restriction may be understood, in financial terms, as the imbalance among the risk associated with a coverage portfolio, the reinsurer's immobilization of resources and its probable profitability.***

From a financial standpoint, it is still attractive but with lower profitability than the one which could be obtained with other options. The alternative of the Latin American insurers is to create a better combination than the one the reinsurer may obtain with other lines. In addition, it is necessary to review the reinsurer's classification and selection process to have efficient portfolio options.

Markowitz's Portfolio Theory will help support, from the underwriting point of view, the process of selection of alternatives applying the "risk-profitability" principle. This method provides the tools to make an optimum selection of investment instruments, maximize profits and achieve diversification.

The model also takes into account the balance between price and profitability, and guarantees the updating of market information through an ongoing and dynamic procedure. Likewise, it evaluates each alternative's behavior, i.e., it compares the results and follows them up.

The purpose of the model is to determine the risk of an instrument and its expected profitability to classify and select it according to the investor's need. This may be explained by the following equation:

$$RA = R_f + \beta (R_M - R_f)$$

where:

**RA** = surety portfolio profitability

**R<sub>f</sub>** = risk-free asset profitability

**R<sub>M</sub>** = financial market profitability

**β** = Beta (market deviation)

**(R<sub>M</sub> - R<sub>f</sub>)** = risk premium



The model makes it possible to explain the capacity issue based on the “risk-profitability” principle and the Portfolio Theory. Insurers should generate a higher profitability than the market average to continue to be competitive. Surety bonds face a double challenge: the risk has to be reduced through a system which allows estimating “**the probable maximum loss**” (PML) and a rate which ensures a higher profitability than the one that may be obtained with capital immobilization.

These assessments will be tested with the statements of income of the sector’s representative operators and the evolution will be measured for five years (**2006-2010**). For this scenario a series of assumptions have been introduced, which makes it possible to discard certain variables and determine the influence and importance of capacity and profitability in each insurer’s strategy. The figures have been taken from accounting records and reinsurance automatic capacity from the reinsurance treaties<sup>2</sup> yearly submitted to the regulatory agency. The figures have been converted to constant currency and the unit of measurement was the US dollar to avoid distortions in comparison.

**Surety market:** Argentina

**Currency:** US dollars (at the rate of exchange of the Banco de la Nación Argentina at each financial statements’ closing date).

**Assumption 1:** Maximum annual amount: 15 times the capacity of the automatic reinsurance treaty.

**Covers:** three, public works, private works and customs guarantees.

**Number of operators:** 5

1. **Leader:** monoliner (shareholder: Common investment fund)
2. **Follower 1:** monoliner – Traditional operator (shareholder: family company)
3. **Follower 2:** monoliner – New operator (shareholder: family company)
4. **Follower 3:** multiliner – (shareholder: US holding)
5. **Follower 4:** multiliner – (shareholder: Spanish holding)

I propose dividing this study into stages to analyze **competitiveness**:

- **Positioning analysis:** The return and management parameters are used to make a comparative table of each company’s evolution. Ratios are very useful as they allow relating elements that by themselves cannot generate information but, combined with others, describe the behavior of an activity. Their main advantage is that they help make a quick diagnosis of the positioning of each company and the industry.
- **Competitiveness matrix:** Based on the ratios and each company’s evolution, their positioning is plotted on a graph to help interpret each operator’s strengths and weaknesses in competitiveness. The matrix simultaneously assesses the attractiveness of the line based on the reinsurer’s vision to allocate capacity to each company. The graph allows the identification of the variables to be changed by each company to solve their problem of strategic positioning and capacity.

## ■ Positioning analysis

YEARS	2006				2010							
ITEM	MS	Ces.	Efic K	Ret K	MS	Var %	Ces.	Var %	Efic K	Var %	Ret K	Var %
LEADER	20%	61%	30%	10%	15%	-24%	59%	-3%	24%	-20%	8%	-20%
FOLLOWER 1 (MONO)	10%	55%	16%	5%	10%	-2%	49%	-10%	26%	63%	8%	60%
FOLLOWER 2 (MONO)	8%	55%	36%	14%	16%	105%	46%	-16%	39%	8%	17%	21%
FOLLOWER 3 (MULTI)	3%	56%	28%	8%	3%	0%	51%	-9%	28%	0%	9%	13%
FOLLOWER 4 (MULTI)	3%	77%	74%	37%	2%	-37%	61%	-20%	27%	-64%	10%	-73%
AVERAGE	44%	61%	37%	15%	46%	5%	53%	-12%	29%	-22%	10%	-30%

Four parameters are used to make a comparative study for each company in order to assess their evolution in the period analyzed. Two of the criteria applied were specially developed to measure reinsurance capacity use: capital efficiency (**Efic K**) and return on capital (**Ret K**), which are added to the traditional ones: market share (**MS**) and percentage of reinsurance cession (**Ces**).

<sup>2</sup> For information on the Argentine market capacity, please visit: <http://www.afip.gov.ar/>

- **Capital efficiency (Efic K):** It is derived from dividing the annual premium by the automatic capacity. This ratio measures the efficient use of capacity as a resource and assesses its importance in the strategy as a source of differentiation.
- **Return on capital (Ret K):** It is derived from dividing the net marginal contribution of reinsurance by the automatic capacity. For the reinsurer, this is the expected return parameter based on the level of capital immobilization. For the company, it is the return on an asset considered a critical resource.
- **Percentage of cession (Ces):** It refers to the portion of risks the cedent transfers to the reinsurer. As most surety contracts in Argentina are of a proportional quota share type, the reinsurer assumes a fixed percentage of all the cedent's risks. It serves two purposes: first, it is the portion of income that will offset operation costs and, second, it defines the maximum risk exposure per client assumed by the company.
- **Market share (MS):** It represents the company's degree of participation in the whole market. It is the ideal indicator to profit from the benefits when the industry is in the growth stage. Currently, it needs to be supplemented with other criteria.

**Based on the ratio analysis, it follows that:**

- The ten major players are still concentrating **80%** of the operations. Yet, the ranking has changed as companies have entered and exited the market.
- The low average loss ratio (**7.3% in 2006; 4.8% in 2008; 4.5% in 2010**) explains the lower percentage of cession to increase the local profit margin earned directly by the companies.
- In this first analysis, for the reinsurer, capacity involves a high capital immobilization and a low use of the resource, so its idle capacity is high and the return is low.

#### ■ **Strategic positioning matrix (See Graph 2, at the end of the Annex section)**

For a visual interpretation of each operator's positioning, a matrix was drawn up to associate the reinsurer's criterion to allocate capacity to each company (**risk-return principle**) with each market segment capacity (**BCG matrix**). The objective is to check whether the strategy is in tune with a consistent segment selection and positioning in relation to the reinsurance demand.

From this combination we can identify four sectors, as follows:

- **Star:** Market with high growth and return rates and low risk level. In this sector capacity can easily be obtained. The return on the product is higher than the average and the associated risk is low.
- **Question mark:** High-growth market with high return and risk. The return attracts the reinsurer but its participation is restricted to automatic treaties. The challenge of facultative treaties is to reduce the risk by providing the reinsurer with more information for decision-making.
- **Dog:** A declining market, with low return and high risk. For the reinsurer, the only strategy is to restrict its participation to automatic treaties where short-term coverage is underwritten.
- **Cash cow:** Mature market with low growth rates, return and risk. The attractiveness for the reinsurer is its low risk due to the effectiveness of the underwriting policy. The strategy is to reposition the company through a tactic focused on cost-effective resources to obtain the highest profitability.

Based on the evolution of each company's ratios and their comparative analysis, the position of each operator was determined by the competitiveness criterion. The strategy of **Follower # 2** stands out because, being an operator with less than ten years in the industry, it ranked second in market share with an efficient use of reinsurance (**+39%**) and a 17% return on capacity.

- **Automatic reinsurance (A):** Its place in the "cash cow" sector requires a higher return to reposition it as an alternative attractive to the reinsurers. The objective is to change from a price determined by the demand to the application of a cost-effective method that ensures the highest profit margin.



- **Facultative reinsurance (F):** Its place in the “dog” sector requires an improvement both in the risk and in the return generated by this type of project. It involves changing the strategy, improving the underwriting process and being more efficient in resources management.
- **Argentine surety market:** Five operators concentrate **50%** of the market share but rivalry is greater (the leader transferred **25%**, which was absorbed by a new operator), the retention percentage is higher and the loss of competitiveness is shown by the return ratio **(-30%)** and the efficiency ratio **(-22%)**. For these companies, reinsurance is not a competitive advantage. The idle capacity, which results from the difference between maximum capacity and actual production, shows that only one company uses this resource efficiently. Besides, as the reinsurer's return on capital is low, only the insurance companies are profitable.

### III. Profitability analysis

In the current business scenario, the companies' key objectives come down to two fundamental principles:

- Strengthening and increasing the competitiveness of their products.
- **Strengthening and increasing business profitability.**

This paper focuses on the analysis of the surety line competitiveness from a financial viewpoint, i.e., profitability. The tools used helped identify the gap between market needs and the product. Both the competitiveness and the profitability criteria are used to prove the assumptions. The former checks the degree of compliance with the strategy and the latter, the application of the tactic. Currently, surety bonds are competitive both for clients and brokers, but not for the reinsurers.

The Latin American market is in the midst of a transition process between the growth stage and maturity. As a result, there are two competing strategies. One is the **production strategy**, developed for economic environments with a potentially important market but shortage of supply; in this case products are generally in the growth stage. The company does not need to differentiate or innovate. Marketing focuses on the **4 P's: Product, Price, Promotion and Place**. There is a directly proportional relationship between market share and return because in imperfect competition markets, the price is set based on the supply.

The other is the **strategy focused on the client**, which is suitable for competitive scenarios with mature products. Industry growth is slackening and marketing focuses on the **4 C's: Consumer, Cost, Communication and Convenience**. Due to market stagnation and a large number of operators, the objective is to be efficient to increase the profit margin. In this scenario the price is set based on the demand.

In view of these two strategies, companies are faced with the dilemma of reducing the price or being more cost-competitive. From the Argentine market analysis, it follows that profitability declined between 2006 and 2010. This can be accounted for by the entry of operators, higher competition, lower growth rates and the substitutes.

It could rightly be said that the industry is exiting the growth stage and definitely entering the maturity stage. This entails changing the strategy due to the failure to respond with the traditional tools. Maintaining the market share as a strategic objective in a mature market involves sacrificing profitability not to lose positioning. The strategy focused on the client generates profits by using the resources efficiently and makes it possible to compete with a price that is low but still ensures the highest profitability.

One solution is to delay entering the maturity stage by relaunching and updating the products. Covers have not been changed since their inception; new products are developed but are not marketed by the traditional companies and are underwritten by small monoliners that know how to position, underwrite and manage them efficiently.

Focusing on the same market, a comparative analysis of the methods introduced by the production strategy and the customer strategy will be made to compare the efficiency of each model. The objective is to identify the method by which profitability can be improved based on actual figures. Finally, the conclusions derived from the application of both criteria—competitiveness and profitability—will be combined to assess the consistency between strategy and tactic.

In order to focus on the analysis of the critical variables that determine profitability, assumptions to discard irrelevant variables should be included.

**Assumption 1:** The “maximum annual amount<sup>3</sup>” is derived from the actual reinsurance treaty capacity. Thus, the same percentage can be used for all companies and the advantages of the use of higher capacity are excluded from the analysis.

**Assumption 2:** The number of policies in force<sup>4</sup> per year is a constant dependent on the “maximum annual amount.” It operates in a similar way to Assumption 1 as the possible quantity differences among operators are ruled out from the analysis.

**Assumption 3:** The same distribution percentage for income and costs is used for all the companies. However, the loss ratio has a different distribution based on the loss history of every cover.

**Assumption 4:** To determine the loss ratio of the second scenario, the concept used is the “current cost” rather than the “prudent cost” required by the regulatory agency. The objective is to value claims at the closing of each fiscal year according to the cash value rather than the historical cost. Thus the “holding losses” generated by maintaining this debt over time are recorded. The method is similar to the one used in the automobile insurance line. It is estimated from the nominal value and then an adjustment coefficient is applied depending on the jurisdiction where the claim is filed<sup>5</sup>.

**Assumption 5:** A 50% profit target was set for all companies.

**Type of coverage (3, in total):** Public works guarantees, private works guarantees and customs guarantees. This new scenario is aimed at determining the cost per cover based on the same distribution percentage in order to choose the best mix to generate the highest profits. According to this approach, the cost is the critical variable of the whole process.

#### Differential variables of the new scenario

- **Reinsurance treaty:** The structure adopted by each company has been used. This scenario analyzes the degree of correlation between profitability and the reinsurance method.
- **Calculation method (grossing up):** Calculating the price based on the total cost is a method that can be applied as a criterion to compare covers and companies. A change of strategy involves adopting new methods to calculate profits. While the markup method calculates profits based on the price, the grossing up method does it based on the cost.
- **Distribution criterion (segmentation):** Applying the benefits of strategic marketing, the analysis is broken down into different types of cover and can be supplemented by considering income, expenses and loss ratio.

Actual figures were used to build a second scenario by applying the concepts of the strategy focused on the client. Therefore, two methods are used to calculate profits: the current one, based on the price (markup), and the new one, based on the cost (grossing up). The comparison was made on a price basis by applying a 50% profit margin to the cost of the second scenario.

#### Conclusions from the Argentine market profitability analysis

(See Profitability analysis at the end of the Annex section)

- **Loss ratio:** The change to the loss-adjustment criterion based on the “current cost” is one of the variables that affects the profit margin. Its behavior is similar to that of “automobile liability insurance.” The historical cost criterion does not take into account the updating of the amounts insured, nor does it acknowledge the loss of accrued interests in the accounting records and defers the allocation of the loss to the date it occurred. Besides, this criterion does not allow the reinsurer to assess the impact on its reserves and change the contract conditions. The leader has the highest profit percentage (-12%), and the current structure of reinsurance treaties, especially in monoliners, does not provide for a margin for extraordinary deviations.
- **Structure expenses:** This concept includes acquisition expenses (commissions) and operation costs (fixed costs). The analysis of commissions indicates that monoliners have had to sacrifice their margin to defend their market share. The ones that stand out are: the leader, which

<sup>3</sup> Maximum annual amount = Annual automatic capacity (actual) x 15.

<sup>4</sup> Policies in force = Highest annual amount / 35,000.

<sup>5</sup> The adjustment coefficient of the insured amount in the Argentine judicial system varies according to the type of guarantee: private works guarantee (monthly effective borrowing rate: 0.8%), public works guarantee (monthly effective lending rate: 1.6%) and customs guarantee (monthly effective lending rate: 3%).

escalated from **20% to 25%**; Follower 1, from **30% to 46%**, and Follower 2, from **19% to 26%**, between 2006 and 2010, whereas the other two operators were below the **22%** level in 2010.

Fixed costs remained relatively stable and followed inflation rates. The total cost supports the strategy focused on cost-effective resources and processes as the way to control the profit margin. If it was simultaneously applied to every company, multiliners would be the quickest to take advantage since commissions are semifixed costs and any change will impact later on due to re-invoicing.

- **Reinsurance structure:** From the analysis it follows that the maximum reinsurance capacity is not a competitive advantage for the companies analyzed and that it is neither used as a strategic resource. However, together with the loss ratio, it is a variable that determines the profitability of the industry. We can see that all the operators have increased the retention percentage, but with different purposes.

Multiliners started in 2006 with low retention percentages, which forced them to operate below the underwriting breakeven point. This led to a change of conditions and the range stabilized between 40% and 50%. This reinsurance plan, as well as the efficient use of resources due to the amendments to Resolution 32080, generated higher profits than the market average.

The situation may be summarized as follows:

**↑ Retention + ↓ Cost-effective resources = ↑ Profitability**

On the other hand, monoliners started in 2006 with higher retention levels than multiliners, but continued increasing them for financial reasons. Having a high cost of structure, fixed costs and commissions, they had to retain a greater percentage of risks to have more liquidity to offset them. The accounting explanation is that as long as the retention percentage is determined directly, the profit sharing percentage is revenue dependent on the management results and is fixed at the end of each fiscal year.

The following situation can be summarized as follows:

**↑ Retention + ↑ Cost-ineffective resources = ↓ Profitability**

The comparison shows that monoliners use the reinsurance treaty to defend their market share, while multiliners use it strategically—on top of structure cost and brokers' commissions that are agreed to on a global basis—and may thus obtain higher profits.

The analysis of profitability evolution shows that: the leader declined from **18% to 13%**; Follower 1, from **20% to 2%**; Follower 2, from **14% to 4%**, whereas Follower 3 dropped from **40% to 28%** and Follower 4 escalated from **6% to 16%**.

**Price:** The inclusion of assumptions 1 (maximum annual amount) and 2 (policies in force) allowed me to concentrate on studying the price-profitability relationship. As stated at the beginning of this section, there are currently two strategies based on the product life cycle. Each one uses a different method to calculate profitability. The current one (**markup**) is based on the market price, and the new one (**grossing up**) is based on the company's total cost. By taking into account the conclusions from the above point, it can be deduced that the method that generates the highest profit is the one based on the cost.

The markup method estimates the market price regardless of the cost. This makes some clients operate below the underwriting breakeven point and profit is made by setting off entries. Furthermore, a loss provision for the probability, frequency and intensity of every cover cannot be included in the price.

- **Strategy:** Based on the comprehensive review of the parameters, it follows that the problems of capacity and product cannibalization cannot be solved using a strategy and tools developed for stable and closed scenarios in the growth stage. The environment has changed the industry into an open and dynamic one going into the maturity stage.

To prolong the advantages of a growing market, a change on the supply side should be made. This involves developing covers to meet new needs and updating covers to comply with the new legal framework that, like the market, has also evolved. We are losing business because we cannot adapt ourselves to the new requirements to provide cover for modern contracts. As a result, surety bonds no longer are the only instrument to guarantee private works. Due to the companies' failure to act, the market has encouraged the creation of "reciprocal guarantee companies" which provide both insurance and financial services. These companies select firms dedicated to a specific activity to achieve the vertical integration of the multinationals' production process offering them the combined benefit of financing and private works coverage. Besides, modern agreements, such as trusts, pose a problem to surety bonds as they include new parties that do not fit in the traditional three-party structure of surety bonds. This paper is based on

common daily problems whose recurrence is a sign that we should update our product concept, include new tools and restructure our vision about what purpose we want our product to serve.

#### IV. Competing for the future surety market

As a consequence of the globalization phenomenon, the emergence of a global market has increased the offer of products and the harmonization of the regulatory and financial supervision systems has been recognized as a need.

As each country has the sovereign power to issue its own rules, most probably **Basel and Solvency II** will be the basis to boost a series of public policies aimed to unify criteria.

In Latin America, their impact will depend on the supervisory agencies and to which extent these agencies wish to control the operations. Due to this limitation, the conclusions are valid for the Argentine market only, and the purpose of this paper is to identify and analyze the variables that are transforming the industry.

They are general rules applicable to all kinds of companies, and their implementation poses additional challenges for some lines. Surety bonds, a derivative of a financial instrument, will be affected both by the term and the risk aggregation, which will be analyzed below.

**Solvency II** is a standard for the procedure to be applied to the valuation, disclosure and control of banking and insurance operations. All changes always involve winners and losers. Solvency II fixes the parameters so that investors may apply the same procedure to evaluate their options. The system tries to impose uniform rules for banks and insurers and is based on three pillars: the first one consists of common rules for the valuation of assets, liabilities and the calculation of capital requirements. The second requires supervisory procedures to guarantee the operation of a management, risk control and capital reserves system. Lastly, the third pillar introduces requirements which will allow comparing capitals among companies.

In view of this new scenario, the terms used in this work, such as profitability and competitiveness, contribute to differentiating the line from other options.

The consistency in the regulation of the financial and insurance sectors is particularly important to materialize the principle: **“Equal risk, equal amount of capital.”**

There follows an analysis of the advantages and disadvantages as per type of company: monoliner or multiliner.

##### ■ The impact of Solvency II

In this section, we will deepen the analysis of the first pillar. The implementation of the new regulations will allow bringing the companies' valuation criterion into line with consistent international standards. The use of internal risk models will help change the management culture by improving the decision-making process of the companies. Thus, some concepts, which are key to Basel II, such as economic capital and risk-adjusted capital, and have been scarcely used up to now in emerging countries, will reduce subjectivity in underwriting coverage.

##### ■ Facultative risks: Solvency II directly relates risk to capital.

Monoliners with low net equity will be at a disadvantage to face multiliners which, with higher net equity, have better availability to assume big risks. From the reinsurer's standpoint, this type of operations involves the acceptance of a risk transfer based on an increasingly lower retention percentage. According to this approach, the underwriting of “big risks” will be limited for companies which cannot exhibit equity solvency. Based on this requirement, the reinsurer takes control of the negotiation in a similar fashion to that of the “global programs” and joins the broker and the company. Price, commission and capacity are simultaneously defined. This type of contract encourages the strategic alliance reinsurer-company to meet this demand. It is summarized by the following equations:

**Monoliner:** ↓Net equity + ↓Retention + ↑Excess of Loss (XS) = ↓Big Risks

**Multiliner:** ↑Net Equity + ↑Retention = ↑Big risks

- **Automatic risks:** The impact is lower for this type of contracts. The reinsurer and the company fix the capacity by taking the maximum retention as the limit. The reinsurer will allocate capacity to the companies offering higher return with less capital immobilization. Multiliners with a higher net equity will have access to higher capacity with lower cost because the excess of loss contract is unnecessary. In a competitive scenario multinationals have financial solvency if they decide to work below the breakeven point and displace a competitor.

**Monoliners:** ↓Net equity + ↓Retention + ↑Excess of Loss (XS) = ↓Capacity

**Multiliner:** ↑Net Equity + ↑Retention = ↑Capacity

- **Capital risk:** For both types of company, Solvency II will have economic capital requirements in excess of the regulatory capital. We can conclude that this case is similar to the one of facultative and automatic risks. The consequence of this body of rules is that underwriting has a direct impact on the economic capital. Here we can refer to **Resolution 32080 (2007), Rates system**, where a limit was fixed to the underwriting losses by line in order to match company price with costs. The application of this regulation, specially devised for the automobile industry, entailed a radical change in the companies' strategies whose only concern was to increase their market share without taking into account the underwriting results, which were then offset by the financial ones.
- Multiliners are a step ahead. They had to reshape their strategy and revise their structure costs, loss policies and commission tactics to be competitive again in relation to others who were more efficient. However, monoliners, which were not affected by this resolution due to their positive underwriting results, have not implemented this process or turn it to their advantage.

Finally, to graphically summarize these items, I grouped the consequences of the implementation of Solvency II into four areas. So, I end this paper with a comprehensive review of the present and future industry. A comparative analysis of the evolution of multiliners (modern) and monoliners (traditional) in view of the new regulatory requirements may anticipate the expected future surety market.

ITEM	MONOLINER (TRADITIONAL)	MULTILINER (MODERN)
STRATEGY	<ul style="list-style-type: none"> <li>■ Focused on the client; it implies a higher increase in costs.</li> <li>■ Total coverage strategy.</li> </ul>	<ul style="list-style-type: none"> <li>■ Focused on the client; it does not require major cost adjustments for integral management.</li> <li>■ Portfolio cross-selling; it implies taking advantage of an already positioned niche.</li> <li>■ Niche strategy – Synergy with other lines.</li> </ul>
CAPITAL	<ul style="list-style-type: none"> <li>■ Lower minimum capital requirements.</li> <li>■ Reduced maximum retention.</li> </ul>	<ul style="list-style-type: none"> <li>■ Higher minimum capital requirements.</li> <li>■ Higher maximum retention; it allows assuming big risks.</li> </ul>
COSTS	<ul style="list-style-type: none"> <li>■ Inadequate resources and processes.</li> <li>■ Higher commission to maintain the portfolio.</li> <li>■ Higher structure costs.</li> </ul>	<ul style="list-style-type: none"> <li>■ Adequate resources and processes.</li> <li>■ Global commission.</li> <li>■ Higher absorption of structure costs.</li> </ul>
CAPACITY	<ul style="list-style-type: none"> <li>■ High immobilization and low efficiency.</li> <li>■ Working with all covers involves a higher risk for the reinsurer.</li> </ul>	<ul style="list-style-type: none"> <li>■ Optimization of capacity and higher efficiency.</li> <li>■ It involves a lower risk for the reinsurer due to the more detailed information needed for underwriting.</li> </ul>

**Based on the above table, the following conclusions may be derived:**

- **Multiliners:** They are better positioned to comply with the capital requirements of Solvency II. The 2006-2011 growth rates are higher than those of the monoliners. This may be explained by the confluence of several factors: higher resource leverage, global brand construction, and portfolio cross-selling. For the reinsurer, allocating capacity involves a lower portfolio risk due to the additional information obtained from the operation with other lines. In addition, they use that capacity efficiently due to lower capital immobilization with higher profitability. Lastly, integral



brokers are changing their behavior and benefit from better conditions and higher negotiation power.

- **Monoliners:** With the current change of environment, monoliners have been the hardest hit by globalization, mainly because they adopted a strategy that is not consistent with the product life cycle stage. Likewise, in order not to lose ground, they had to increase commissions and structure expenses to compensate for the business action of the multiliners. As a consequence of this policy, the profitability margin declined. To finance higher expenses they had to change their reinsurance structure by increasing the retention percentage to improve liquidity. They are directly affected by Solvency II. The new capital requirements hinder negotiation and oblige them to assume risks based on retention.

### Development of item III - Profitability Analysis

LEADER - Currency USD										
Item	30/6/06	%	30/6/07	%	30/6/08	%	30/6/09	%	30/6/10	%
Underwritten premiums	18,414,866	100%	22,726,923	100%	28,351,759	100%	24,984,863	100%	24,434,317	100%
Premiums ceded to reins.	-10,410,680	-57%	-12,889,511	-57%	-15,855,196	-56%	-14,933,036	-60%	-14,330,147	-59%
Retained premiums	8,004,186	43%	9,837,413	43%	12,496,563	44%	10,051,827	40%	10,104,170	41%
Operation expenses	-3,617,989	-20%	-4,461,314	-20%	-5,579,791	-20%	-5,237,746	-21%	-5,353,110	-22%
Acquisition expenses	-4,131,274	-22%	-4,694,574	-21%	-6,080,420	-21%	-5,899,788	-24%	-6,012,135	-25%
Reinsurers' commissions	4,079,743	39%	5,382,021	42%	6,614,163	42%	6,235,748	42%	6,037,210	42%
Losses	-1,899,424	-10%	-2,020,658	-9%	-3,098,047	-11%	-2,951,210	-12%	-1,619,543	-7%
Net	2,435,241	13%	4,042,887	18%	4,352,467	15%	2,198,831	9%	3,156,591	13%
REINSURANCE TREATY ANALYSIS										
Marginal contribution	30.42%		41.10%		34.83%		21.87%		31.24%	
Reinsurance capacity	USD 60,000,000		USD 80,000,000		USD 80,000,000		USD 100,000,000		USD 100,000,000	
Capital efficiency	30.69%		28.41%		35.44%		24.98%		24.43%	
Capital profitability	10.55%		9.38%		11.55%		8.70%		8.29%	
LEADER - MARGINAL ANALYSIS BY SEGMENT										
Market share	19.69%		18.45%		17.93%		16.95%		15.91%	
Average AER	1.90%		1.77%		2.20%		1.67%		1.63%	
Average premium	USD 246		USD 227		USD 284		USD 200		USD 195	
PRICE ANALYSIS										
Public works expenses	USD 229	-7%	USD 167	-27%	USD 211	-26%	USD 239	20%	USD 179	-9%
Private works expenses	USD 370	51%	USD 257	13%	USD 431	52%	USD 359	80%	USD 239	22%
Customs expenses	USD 278	13%	USD 233	3%	USD 328	16%	USD 354	77%	USD 234	19%
RATE ANALYSIS										
Public works expenses	1.91%	0.5%	1.39%	-21%	1.76%	-20%	1.60%	-4%	1.49%	-9%
Private works expenses	3.08%	62%	2.14%	21%	3.59%	63%	2.39%	44%	1.99%	22%
Customs expenses	2.32%	22%	1.95%	10%	2.73%	24%	2.36%	42%	1.95%	19%

FOLLOWER 1 (MONOLINER) - Currency USD										
Item	30/6/06	%	30/6/07	%	30/6/08	%	30/6/09	%	30/6/10	%
Underwritten premiums	9,539,397	100%	12,539,584	100%	17,594,821	100%	16,253,815	100%	15,752,659	100%
Premiums ceded to reins	-5,175,160	-54%	-7,225,738	-58%	-10,478,587	-60%	-8,947,085	-55%	-8,081,499	-51%
Retained premiums	4,364,237	46%	5,313,845	42%	7,116,234	40%	7,306,731	45%	7,671,160	49%
Operation expenses	-1,429,887	-15%	-2,028,471	-16%	-3,055,590	-17%	-2,957,476	-18%	-2,897,070	-18%
Acquisition expenses	-2,898,652	-30%	-4,432,017	-35%	-6,282,527	-36%	-6,845,310	-42%	-7,215,777	-46%
Reinsurers' Commissions	1,904,589	37%	2,460,894	34%	5,075,589	48%	3,210,664	36%	2,993,913	37%
Losses	-14,283	0%	90,533	1%	-247,178	-1%	-355,152	-2%	-190,514	-1%
Net	1,926,005	20%	1,404,784	11%	2,606,528	15%	359,456	2%	361,711	2%
REINSURANCE TREATY ANALYSIS										
Marginal contribution	44.13%		26.44%		36.63%		4.92%		4.72%	
Reinsurance capacity	USD 60,000,000		USD 60,000,000		USD 60,000,000		USD 60,000,000		USD 60,000,000	
Capital efficiency	15.90%		20.90%		29.32%		27.09%		26.25%	
Capital profitability	5.45%		7.94%		9.00%		9.56%		8.48%	
FOLLOWER 1 (MONOLINER) – MARGINAL ANALYSIS BY SEGMENT										
Market Share	10.00%		10.00%		11.13%		11.03%		10.26%	
Average AER	0.97%		1.28%		1.82%		1.81%		1.75%	
Average premium	USD 127		USD 167		USD 235		USD 217		USD 210	
PRICE ANALYSIS										
Public works expenses	USD 106	-16%	USD 187	12%	USD 190	-19%	USD 301	39%	USD 296	41%
Private works expenses	USD 107	-16%	USD 181	8%	USD 212	-10%	USD 319	47%	USD 306	46%
Customs expenses	USD 107	-16%	USD 182	9%	USD 202	-14%	USD 318	47%	USD 306	45%
RATE ANALYSIS										
Public works expenses	0.89%	-8.2%	1.55%	21%	1.58%	-13%	2.51%	39%	2.47%	41%
Private works expenses	0.90%	-7%	1.51%	18%	1.77%	-3%	2.65%	47%	2.55%	46%
Customs expenses	0.89%	-8%	1.52%	19%	1.68%	-8%	2.65%	47%	2.55%	45%

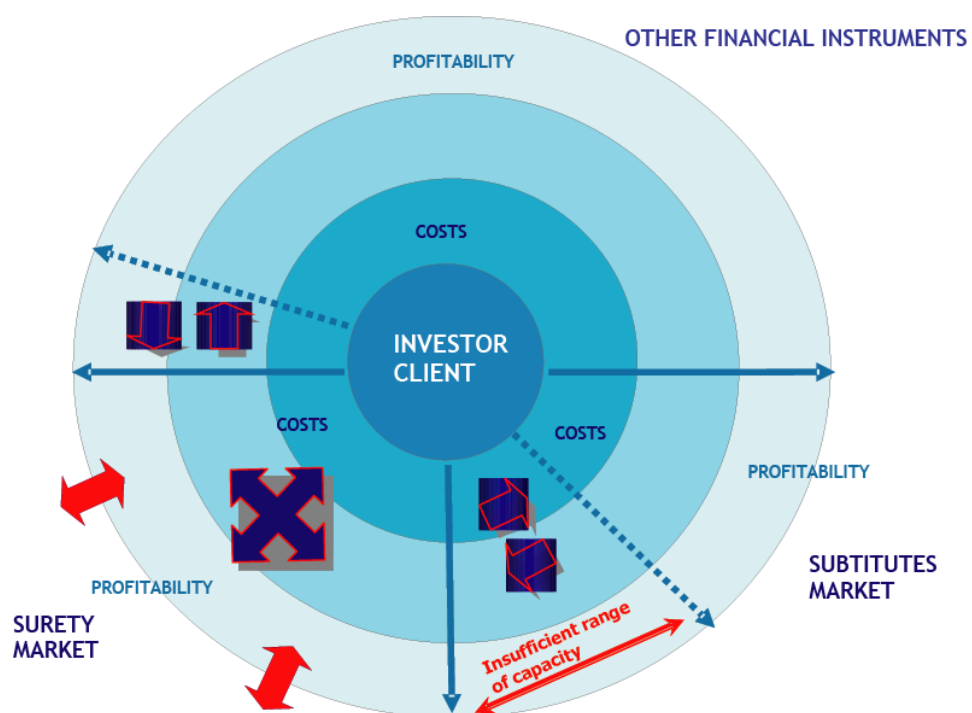
Follower 2 (MONOLINER, New Player) – Currency USD										
Item	30/6/06	%	30/6/07	%	30/6/08	%	30/6/09	%	30/6/10	%
Underwritten premiums	7,310,738	100%	11,978,177	100%	17,765,260	100%	18,471,519	100%	19,272,764	100%
Premiums ceded to reins	-4,040,877	-55%	-4,430,541	-37%	-9,788,045	-55%	-9,120,174	-49%	-8,912,209	-46%
Retained premiums	3,269,862	45%	7,547,636	63%	7,977,215	45%	9,351,344	51%	10,360,554	54%
Operation expenses	-1,949,471	-27%	-3,060,406	-26%	-4,135,452	-23%	-4,551,644	-25%	-4,816,979	-25%
Acquisition expenses	-1,419,683	-19%	-4,175,495	-35%	-3,818,466	-21%	-5,294,527	-29%	-7,097,028	-37%
Reinsurers' commissions	1,175,783	29%	0	0%	2,999,662	31%	2,627,086	29%	3,014,266	34%
Losses	-29,045	0%	-865,596	-7%	-145,304	-1%	-1,367,125	-7%	-644,944	-3%
Net	1,047,445	14%	-553,861	-5%	2,877,656	16%	765,133	4%	815,869	4%
REINSURANCE TREATY ANALYSIS										
Marginal contribution	32.03%		-7.34%		36.07%		8.18%		7.87%	
Reinsurance capacity	USD 20,000,000		USD 30,000,000		USD 40,000,000		USD 50,000,000		USD 50,000,000	
Capital efficiency	36.55%		39.93%		44.41%		36.94%		38.55%	
Capital profitability	14.33%		25.02%		23.10%		17.39%		16.59%	
Follower 2 (MONOLINER, New Player) – MARGINAL ANALYSIS PER SEGMENT										
Market Share	19.69%		18.45%		17.93%		16.95%		15.91%	
Average AER	2.27%		2.46%		2.81%		2.46%		2.57%	
Average premium	USD 292		USD 319		USD 355		USD 296		USD 308	
PRICE ANALYSIS										
Public works expenses	USD 297	2%	USD 488	53%	USD 336	-6%	USD 469	59%	USD 412	34%
Private works expenses	USD 303	4%	USD 558	75%	USD 356	0%	USD 557	89%	USD 449	46%
Customs expenses	USD 299	2%	USD 540	69%	USD 346	-3%	USD 554	88%	USD 446	45%
RATE ANALYSIS										
Public works expenses	2.47%	8.8%	4.06%	65%	2.80%	0%	3.13%	27%	3.43%	34%
Private works expenses	2.53%	11%	4.65%	89%	2.96%	5%	3.72%	51%	3.74%	46%
Customs expenses	2.49%	10%	4.50%	83%	2.89%	3%	3.69%	50%	3.71%	45%

Follower 3 (MULTILINER) -Currency USD										
Item	30/6/06	%	30/6/07	%	30/6/08	%	30/6/09	%	30/6/10	%
Underwritten premiums	2,793,259	100%	3,593,257	100%	4,885,211	100%	4,732,657	100%	5,071,852	100%
Premiums ceded to reins	-1,566,057	-56%	-1,957,152	-54%	-2,823,332	-58%	-2,388,714	-50%	-2,596,699	-51%
Retained premiums	1,227,202	44%	1,636,105	46%	2,061,879	42%	2,343,942	50%	2,475,153	49%
Operation expenses	-573,787	-21%	-722,565	-20%	-1,163,033	-24%	-1,228,460	-26%	-1,156,168	-23%
Acquisition expenses	-316,835	-11%	-560,999	-16%	-615,355	-13%	-634,572	-13%	-781,776	-15%
Reinsurance commissions	777,607	50%	872,980	45%	1,160,358	41%	1,074,117	45%	1,027,847	40%
Losses	1,647	0%	-3,213	0%	-225,633	-5%	106,836	2%	-135,139	-3%
Net	1,115,834	40%	1,222,309	34%	1,218,216	25%	1,661,864	35%	1,429,917	28%
REINSURANCE TREATY ANALYSIS										
Marginal contribution	90.93%		74.71%		59.08%		70.90%		57.77%	
Reinsurance capacity	USD 10,000,000		USD 10,000,000		USD 15,000,000		USD 15,000,000		USD 18,000,000	
Capital efficiency	27.93%		35.93%		32.57%		31.55%		28.18%	
Capital profitability	7.88%		10.84%		11.09%		8.76%		8.72%	
Follower 3 (MULTILINER) - MARGINAL ANALYSIS PER SEGMENT										
Market Share	7.05%		2.92%		3.25%		3.61%		3.30%	
Average AER	1.73%		2.24%		2.16%		2.10%		1.88%	
Average premium	USD 223		USD 287		USD 261		USD 252		USD 225	
PRICE ANALYSIS										
Public works expenses	USD 31	-86%	USD 109	-62%	USD 127	-51%	USD 119	-53%	USD 134	-41%
Private works expenses	USD 31	-86%	USD 110	-62%	USD 211	-19%	USD 100	-60%	USD 158	-30%
Customs expenses	USD 31	-86%	USD 109	-62%	USD 172	-34%	USD 101	-60%	USD 155	-31%
RATE ANALYSIS										
Public works expense	0.26%	-85%	0.91%	-60%	1.06%	-51%	0.99%	-53%	1.12%	-41%
Private works expense	0.26%	-85%	0.91%	-59%	1.76%	-18%	0.83%	-60%	1.31%	-30%
Customs expenses	0.26%	-85%	0.91%	-59%	1.43%	-34%	0.84%	-60%	1.29%	-31%



Follower 4 (MULTILINER) -Currency USD										
Item	30/6/06	%	30/6/07	%	30/6/08	%	30/6/09	%	30/6/10	%
Underwritten premiums	2,966,294	100%	3,297,291	100%	3,484,806	100%	2,212,870	100%	2,745,239	100%
Premiums ceded to reins	-2,201,866	-74%	-2,341,364	-71%	-2,452,079	-70%	-1,518,182	-69%	-1,673,556	-61%
Retained premiums	764,428	26%	955,927	29%	1,032,727	30%	694,688	31%	1,071,683	39%
Operation expenses	-705,841	-24%	-813,739	-25%	-879,408	-25%	-455,009	-21%	-622,449	-23%
Acquisition expenses	-488,505	-16%	-556,151	-17%	-636,914	-18%	-567,273	-26%	-602,067	-22%
Reinsurers' commissions	719,195	33%	788,770	34%	801,159	33%	514,377	34%	611,930	37%
Losses	-118,056	-4%	-39,190	-1%	306	0%	-24,499	-1%	-28,450	-1%
Net	171,222	6%	335,618	10%	317,870	9%	162,283	7%	430,647	16%
REINSURANCE TREATY ANALYSIS										
Marginal contribution	22.40%		35.11%		30.78%		23.36%		40.18%	
Reinsurance capacity	USD 4,000,000		USD 5,000,000		USD 5,000,000		USD 10,000,000		USD 10,000,000	
Capital efficiency	74.16%		65.95%		69.70%		22.13%		27.45%	
Capital profitability	37.07%		31.05%		33.02%		10.04%		10.62%	
Follower 4 (MULTILINER) - MARGINAL ANALYSIS PER SEGMENT										
Market Share	7.05%		2.68%		2.20%		2.02%		1.79%	
Average AER	4.79%		4.26%		4.51%		1.48%		1.83%	
Average premium	USD 593		USD 528		USD 558		USD 177		USD 220	
PRICE ANALYSIS										
Public works expenses	USD 647	9%	USD 498	-6%	USD 666	19%	USD 398	125%	USD 193	-12%
Private works expenses	USD 883	49%	USD 539	2%	USD 666	19%	USD 418	136%	USD 204	-7%
Customs expenses	USD 718	21%	USD 529	0%	USD 666	19%	USD 418	136%	USD 203	-8%
RATE ANALYSIS										
Public works expenses	5.39%	13%	4.15%	-3%	5.55%	23%	1.66%	12%	1.61%	-12%
Private works expenses	7.36%	54%	4.50%	5%	5.55%	23%	1.74%	18%	1.70%	-7%
Customs expenses	5.98%	25%	4.41%	3%	5.55%	23%	1.74%	18%	1.69%	-8%

Graph 1: Current situation of the Argentine market structure



Graph 2: Competitiveness analysis of the Argentine market

