

# OLIVER WYMAN

## Financial Services

September 2011

### **Russian Insurance CEO Survey 2011** “Quo Vadis Strakhovanie”

Synthesis of survey results

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FRA-MOWBK1MKT-322



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Section 1

# **Introduction to the Russian Insurance CEO Survey 2011**



## Introduction to the Russian Insurance CEO survey 2011

- This document reports on an anonymous survey among top Russian insurance executives, gauging their view on the Russian insurance market development in 2011 and 2012. The survey was conducted by Oliver Wyman, a leading global strategy consultancy for the financial services industry, in partnership with the All Russian Insurance Association. It is the third survey of its kind, following the 2009 and 2010 surveys, both of which turned out to be highly predictive of the Russian Insurance market's development.
- The information presented in this document is predominantly based on the anonymous responses of survey participants, and has been tested and confirmed in follow-up interviews with CEOs and board members of leading Russian insurance companies.
- Since the close of data collection the official H1 2011 results have become available, showing that GWP has indeed returned to double digit YoY growth. This information was not available to survey participants at the time of the survey. By now, our follow-up interviews indicate that most CEOs expect 13% to 15% GWP growth for 2011 and even higher growth for 2012, but are also convinced that profit margins will remain under pressure
- In interpreting the information presented in this document, it is important to keep the following in mind:
  - The data represents the opinions of those who completed the questionnaire. They do not necessarily reflect the opinions of either ARIA or Oliver Wyman. However, judging from the results of the 2009 and 2010 surveys, which accurately predicted what happened in the market in those years, the joint opinion of CEOs is authoritative
  - At times, individual answers appear somewhat contradictory, and for some questions answers do not converge on a common opinion. Wherever we felt that the lack of convergence was indicative of disorientation / uncertainty or two opposing but perfectly viable positions, we have made this explicit
  - Where appropriate, we include post-survey interview results to supplement data interpretation
  - In the synthesis section, we provide our own view on the market dynamics over a 5 year horizon
- Our hope is that the results of this work will serve as a basis for further discussion among senior industry leaders, and between the Industry, its Regulator and the State, with the goal to establish a common view on how to best develop the Russian Insurance market to achieve its full potential.

Section 2

## **Reflections on industry dynamics in 2010**

## Reflection on the Russian Insurance market dynamics in 2010

- After the crisis year 2009, 2010 turned out to be another difficult year for the Russian Insurance sector. Premium growth returned, but this growth was below inflation and not enough to break the cycle of destructive competition on price and commission. In fact, liquidity pressure remained a key driver of competitive behaviour and while investment results improved, access to fresh capital remained difficult. Strategic investors remained cautious about new investment, despite a rebounding economy, following a general trend of discounting Russia versus the other BRICs, and investment into the development of their existing insurance assets was scaled back.
- At the beginning of 2010, most insurers had exhausted “anti crisis” cost cutting measures. Done in haste and often unbalanced, without subsequent structural improvements to their operations, these measures did not lead to strategic differentiation. By Q2 insurers started to feel raising salary cost in line with returning opportunity for talented staff. As a result, continued competition on price and commission remained for many the most obvious strategic choice. Disappointed with financial performance, shareholders started to dismiss senior executives, kicking off an “executive carousel” which brought change to individual companies but little fresh talent to the market.
- The exit (through bankruptcy or other) of weak players did not happen to the expected extent. While customers and distribution partners started to migrate to large insurers and established brands in a quest for financial and operational stability, the consolidation progressed slower than anticipated. In fact, the market proved once more to be structurally inert and surprisingly resilient to change. With growth returning, old mindsets and practices have come back. Most insurers did not:
  - Fundamentally change their strategies
  - Implement fundamental operational improvements
  - Negotiate lower commission levels and address key structural issues in distribution
  - Exit the cash flow operating model
- As a result, the market as a whole continues to be worth less than half of its value in mid 2008, despite premium achieving 2008 level. CEOs know this and understand that the criteria for valuation of their companies have moved from premium volume to include several other indicators such as profitability and operational sustainability. However, shareholders seem to continue to push their companies to indiscriminate growth in expectation (or hope?) of top-line driven valuations and deals.
- 2011 and 2012 will likely see a return to double digit growth, but will likely not see a fundamental recovery of margins. The mechanisms of destructive competition remain mostly in place, the market remains structurally inert and expected growth throws a lifeline to the cash flow operators. There is an argument, that inter market competition will not break this deadlock in the near term. However, a medium term remedy seems to be regulatory and legislative action. Given the role that insurance can play for the International Financial Centre initiative, such actions seem now more likely than before.

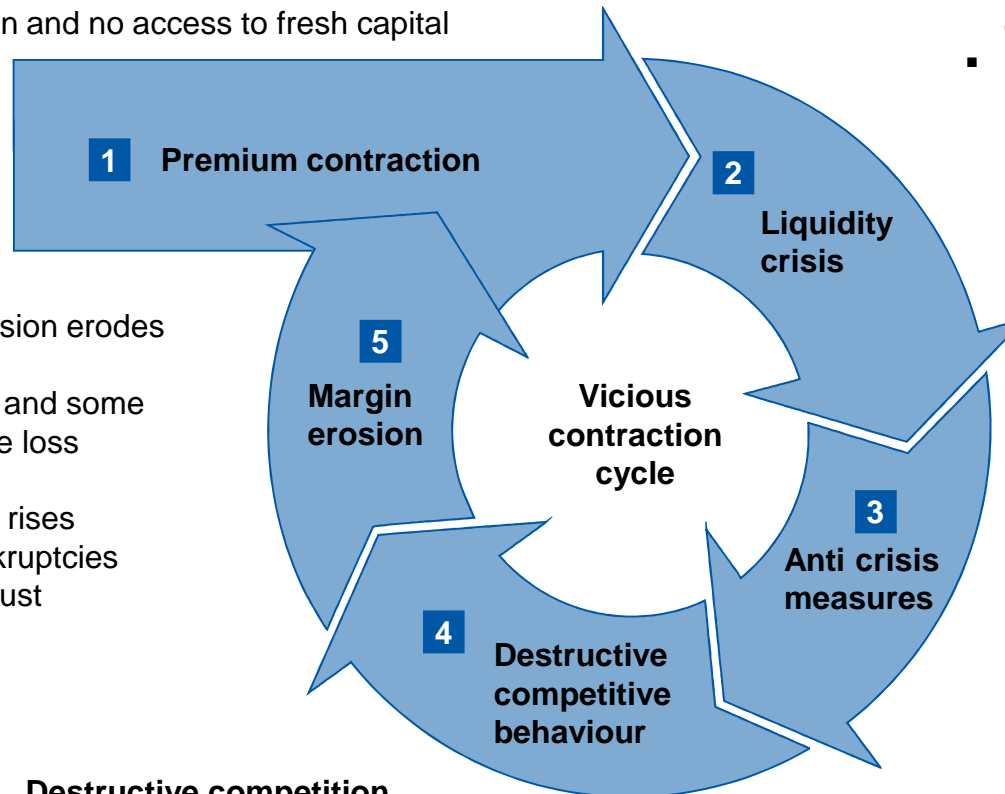
## The global financial crisis triggered a cycle of premium and margin contraction and destructive competitive behaviour in the Russian insurance market in 2009

### Premium contraction

- Negative premium growth
- Negative/weak investment results
- Undercapitalisation and no access to fresh capital

### Margin erosion

- Competition on price and commission erodes margins further
- Demand declines and some core segments are loss making
- Liquidity pressure rises
- Defaults and bankruptcies erode customer trust



### Liquidity crisis

- Cash flow operating model exposed to premium contraction
- Most small and many larger insurers in critical liquidity situation<sup>1</sup>

### Anti crisis measures

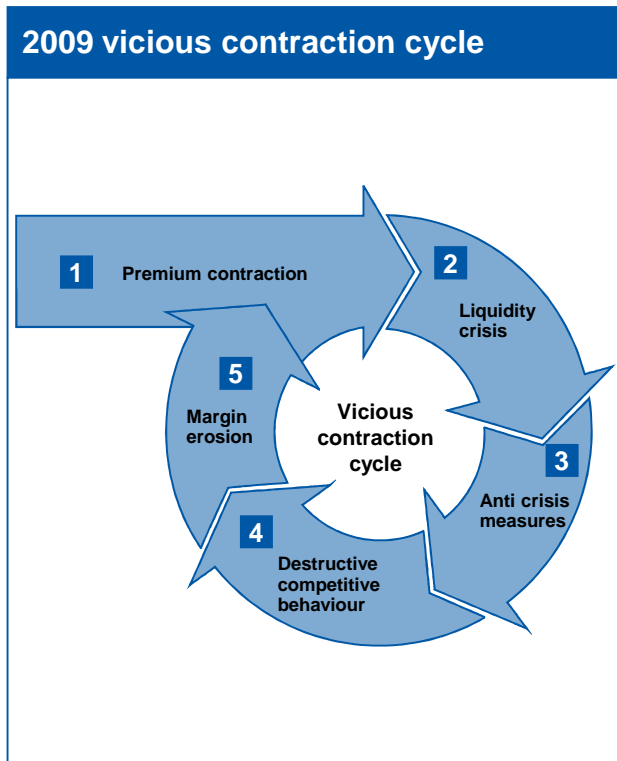
- Often unbalanced and too short-term focused<sup>1</sup>
- Often disabling strategic capabilities
- Rarely leading to strategic differentiation

### Destructive competition

- After near term cost cutting is exhausted, competition on price and commission are often the only remaining strategic options

1. Oliver Wyman Crisis Impact Survey December 2008 / January 2009

## Despite the return of growth in 2010, the dynamics of destructive competition prevailed as growth remained below inflation



### 2010 industry dynamics

#### 1 Premium

- Growth returned with 8.2%, but remained below inflation
- Investment results improved but remained volatile
- Access to fresh capital remained difficult

#### 2 Liquidity

- Cash flow operating model still dominating insurance
- 2/3 of CEOs report that critical liquidity pressure persists

#### 3 Operating cost

- Quick cost savings are exhausted
- Salaries and rents increasing in line with economic recovery
- Operational efficiency still at pre crisis level

#### 4 Competitive behaviour

- Lack of financial resources and unbalanced “anti crisis measures” leave little choice but to compete on price and commissions

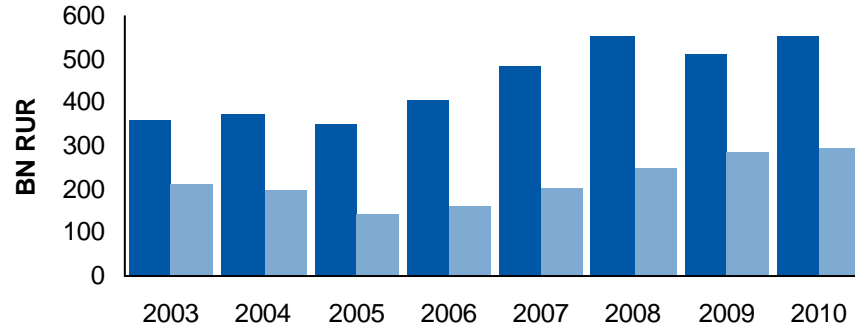
#### 5 Margins

- Competition on price and commission continued to erode margins
- Below inflation growth is not enough to ease liquidity pressure, but provides life-line to cash flow operating model

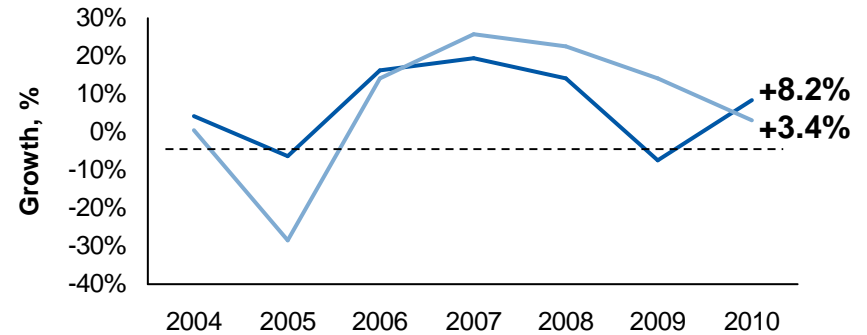
Source: Oliver Wyman Russian Insurance CEO Survey 2010

**In 2010, Gross Written Premium increased by 8.2% with premium growth for the first time since years outpacing claims growth of 3.4%**

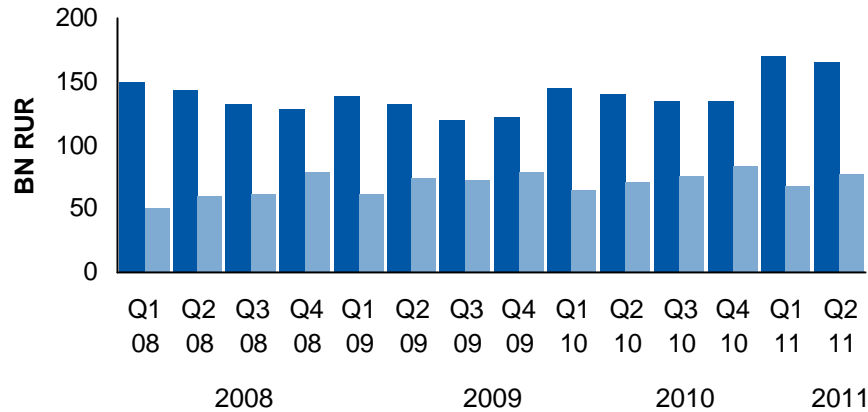
**GWP & claims: Year over Year annual view**



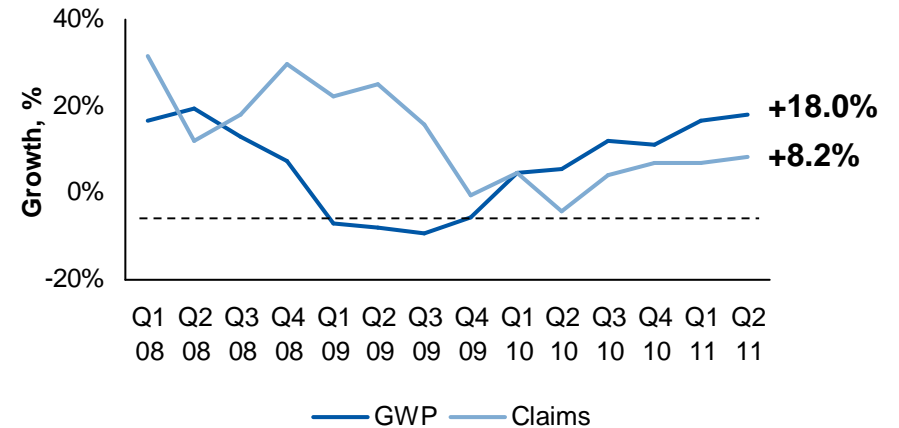
**GWP & claims growth: YoY annual view**



**GWP & claims: Year over Year quarterly view**

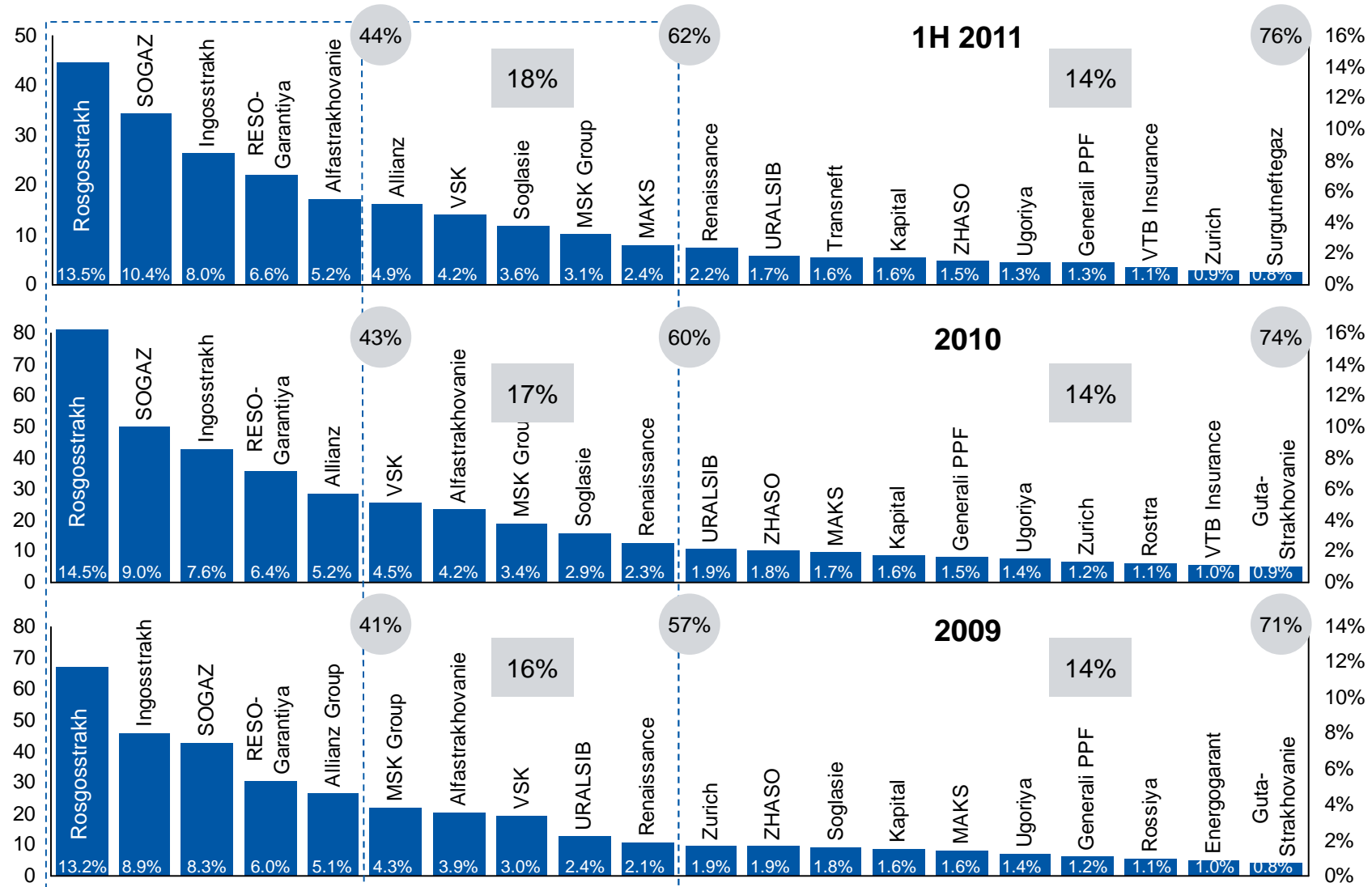


**GWP & claims growth: YoY quarterly view**



Source: Official insurance regulator figures; insur-info.ru; Oliver Wyman analysis  
GWP excludes Obligatory Medical Insurance

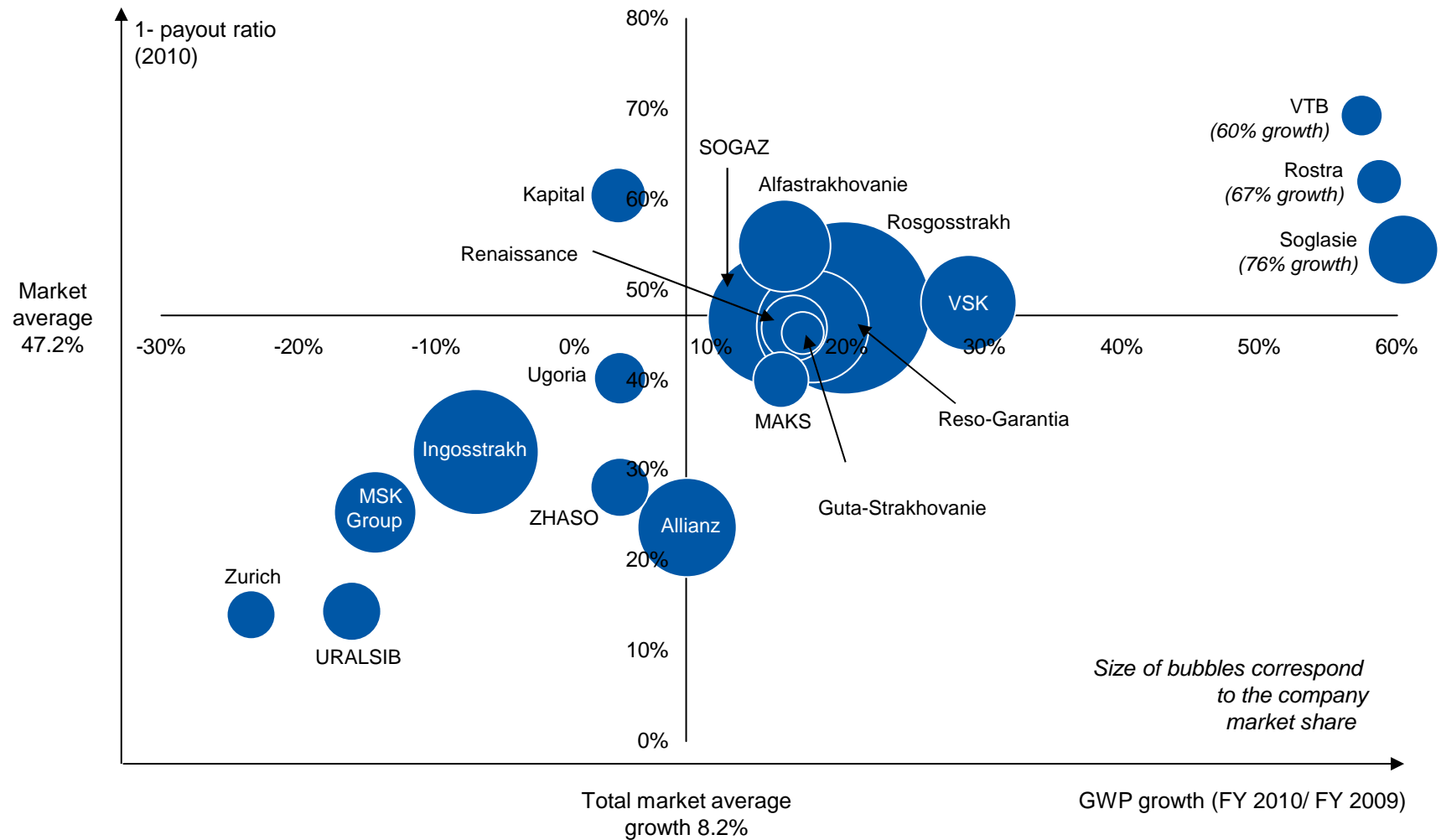
## The top companies solidified their market position and customer and distribution assets migrated to large insurers and established brands



Source: Official Russian insurance regulator statistics (FSSN); Oliver Wyman analysis.

Note – everywhere it applies, the figures given are for the entire insurance group, including its life insurance subsidiaries (e.g. MSK Group includes Spasskie Vorota and MSK Life)

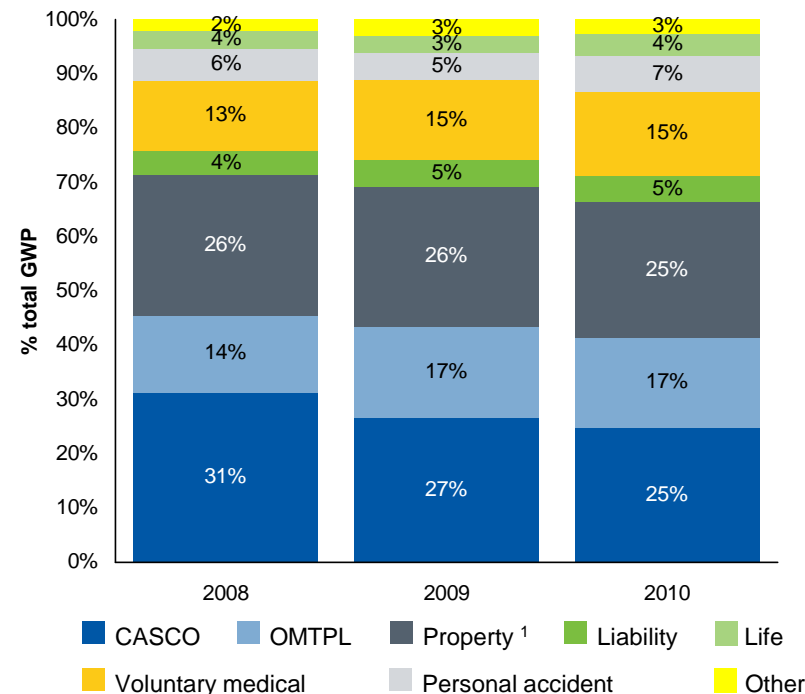
The growth/payout patterns of the Top 20 players shows that company performance varies widely and that cash flow underwriting is still present in the market



Source: Official insurance regulator figures; insur-info.ru; Oliver Wyman analysis.

## Over the last years, the product mix in the Russian insurance market remained fairly stable, discounting externally driven anomalies triggered by the financial crisis

### Market product split



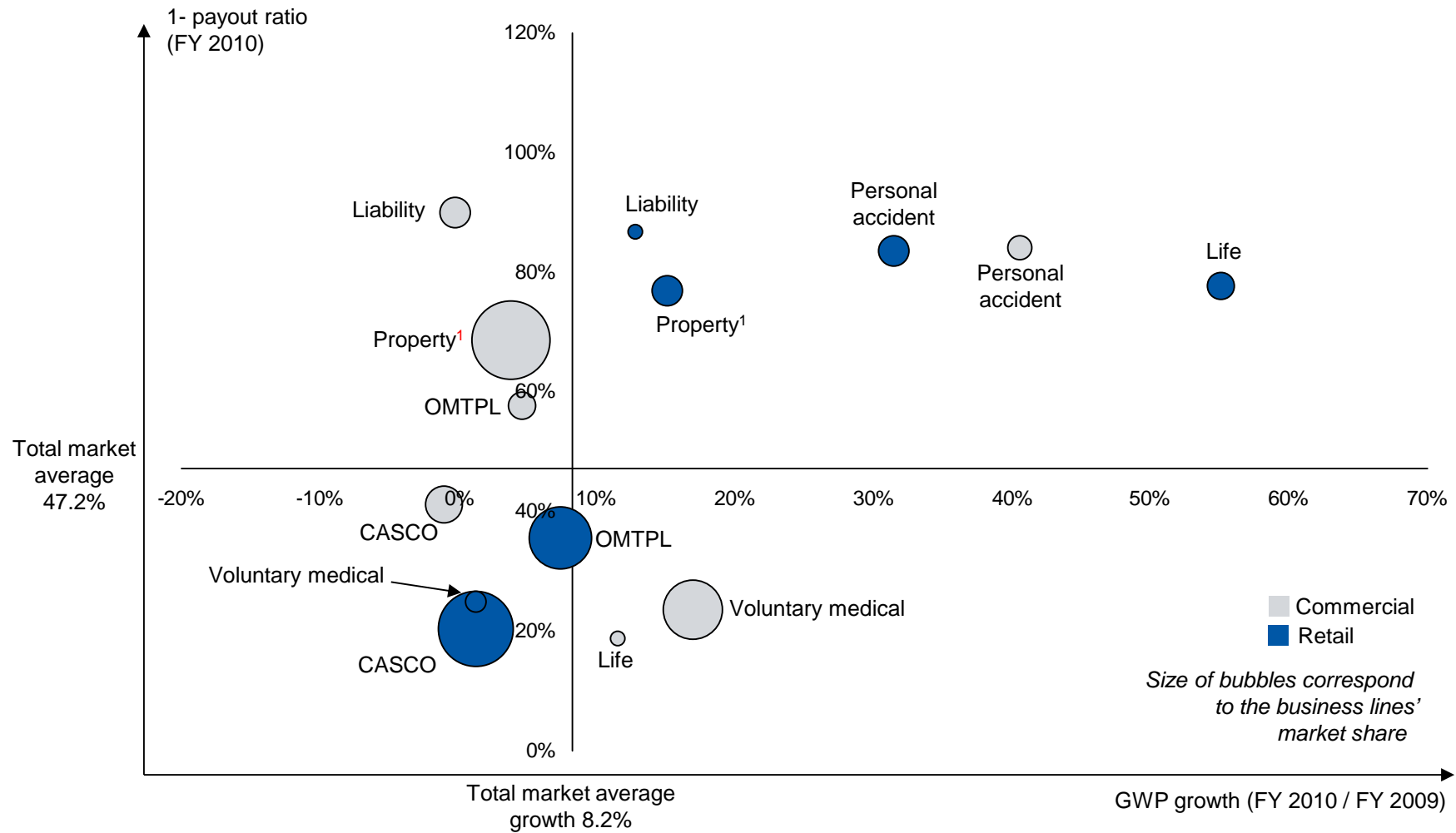
### Comments

- Over the last years, the product mix in the Russian insurance market remained fairly stable
- Little product innovation has been observed specifically in the retail segments (for example very little product differentiation in the motor segment)
- The shifts in 2009 / 2010 product mix are externally driven:
  - CASCO lost significant volume in the crisis in line with significant reduction in sales of new cars. This volume will be regained with the economic recovery
  - Voluntary Medical remained fairly resilient in the crisis as employers did not significantly cut back on employee benefits. The segment maintained the same share in 2010 as in 2009
- While our 2010 Insurance CEO survey showed product innovation for the first time in the top three CEO priorities, this remains an aspiration not supported by market observations

**There is significant inertia (and therefore opportunity for companies) in broadening the product/service offering**

Source: Official insurance regulator figures; Oliver Wyman analysis.  
1. Total property excluding CASCO.

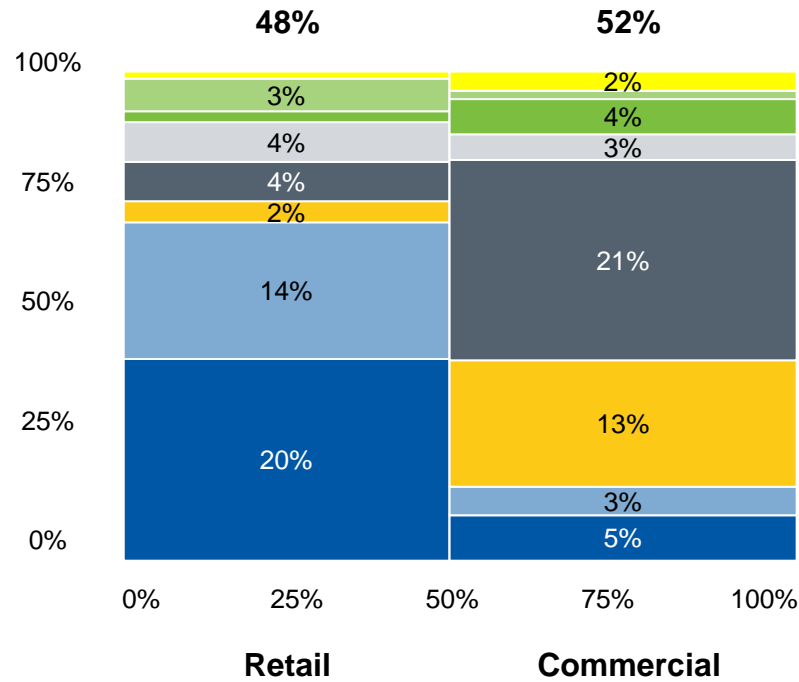
**In 2010, retail lines outgrew commercial lines (9.5% versus 7.0%), however, commercial lines showed better payout ratios than retail**



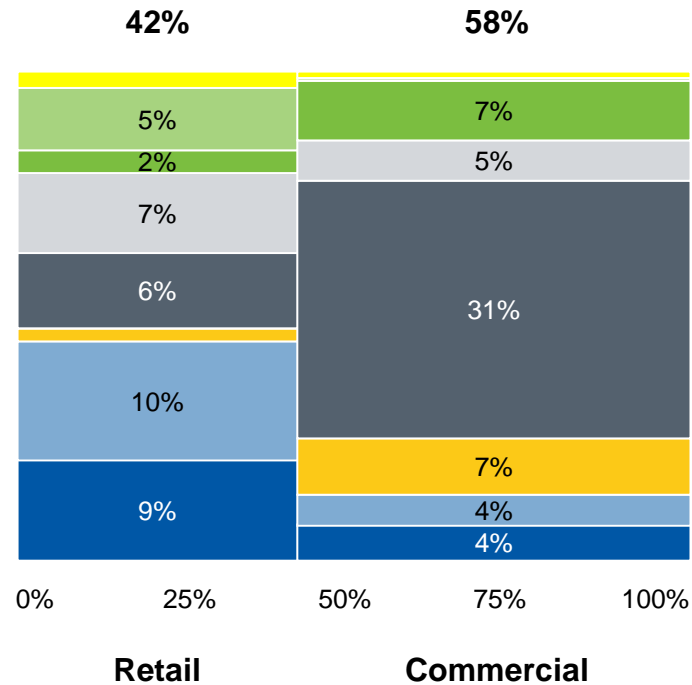
Source: Official insurance regulator figures, Oliver Wyman analysis  
 1. Total property excluding CASCO.

**Profits are concentrated in property lines with commercial property contribution almost 1/3 of cash flows after claims payouts**

**Market Gross Written Premium**  
(Premium pools), FY 2010



**Market profitability (1-payout ratio)<sup>1</sup>**  
("Profit" pools), FY 2010



■ CASCO  
 ■ OMTPL  
 ■ Property<sup>2</sup>  
 ■ Liability  
 ■ Voluntary medical  
 ■ Personal accident  
 ■ Life  
 ■ Other

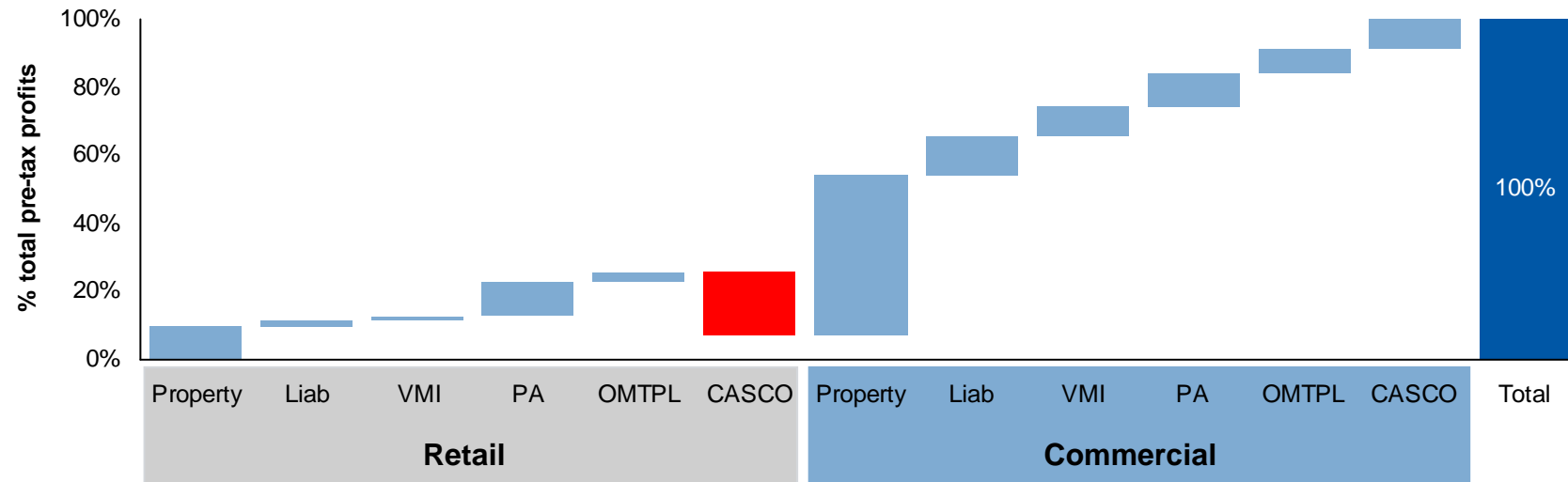
Source: Official insurance regulator figures; Oliver Wyman analysis.

1. "Profit pools" proxy as: GWP less claims payouts. Does not include commission cost, operating expenses and investment income

2. Total property excluding CASCO.

## Accounting for acquisition and administration cost creates an even clearer picture of profits highly concentrated in Commercial lines – Retail CASCO makes a loss

**Pre-tax profits – full expense load<sup>1</sup>**  
(Net Profit pools) FY 2010



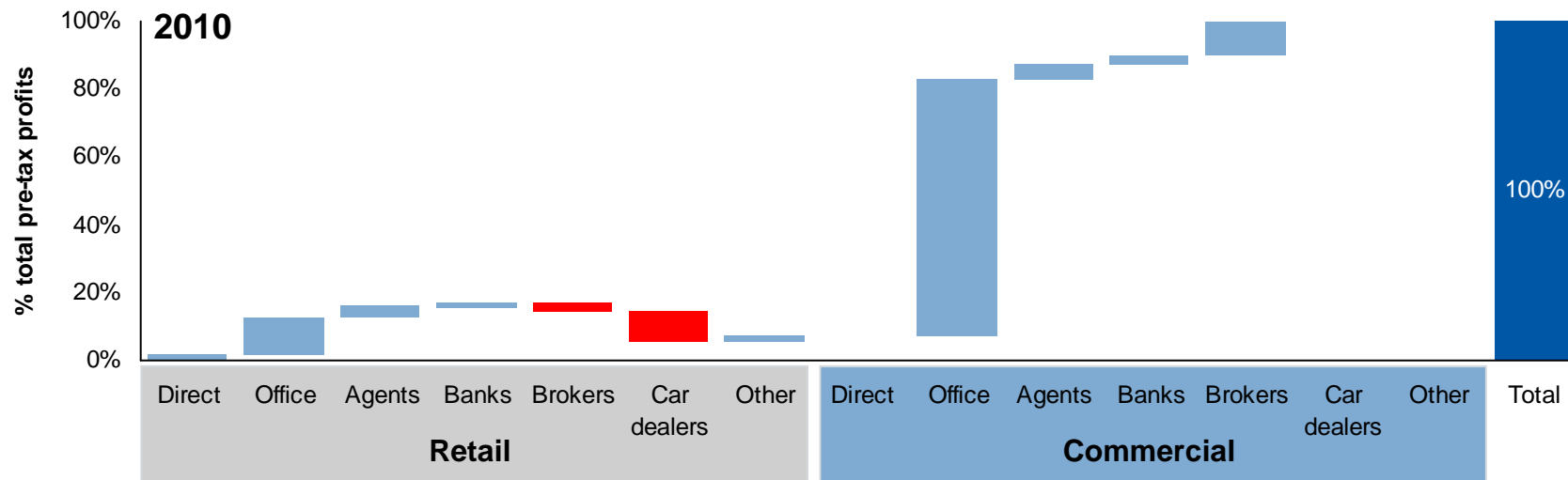
- Commercial property accounts for almost 50% of total industry profits
- Accounting for the losses in Retail CASCO, the share of Retail in overall profits is below 10%
- Retail profits are driven by home insurance and personal accident

Source: Oliver Wyman product / channel premium and profit pool analysis 2010

1. Pre-tax profits include full claims cost, acquisition cost and administration cost as well as investment income

**Profits are highly concentrated in office sales, while motor heavy channels have low profitability (agents) or are overall loss making (car dealers and retail brokers)**

**Pre-tax profits – full expense load<sup>1</sup>**  
(Net Profit pools) FY 2010



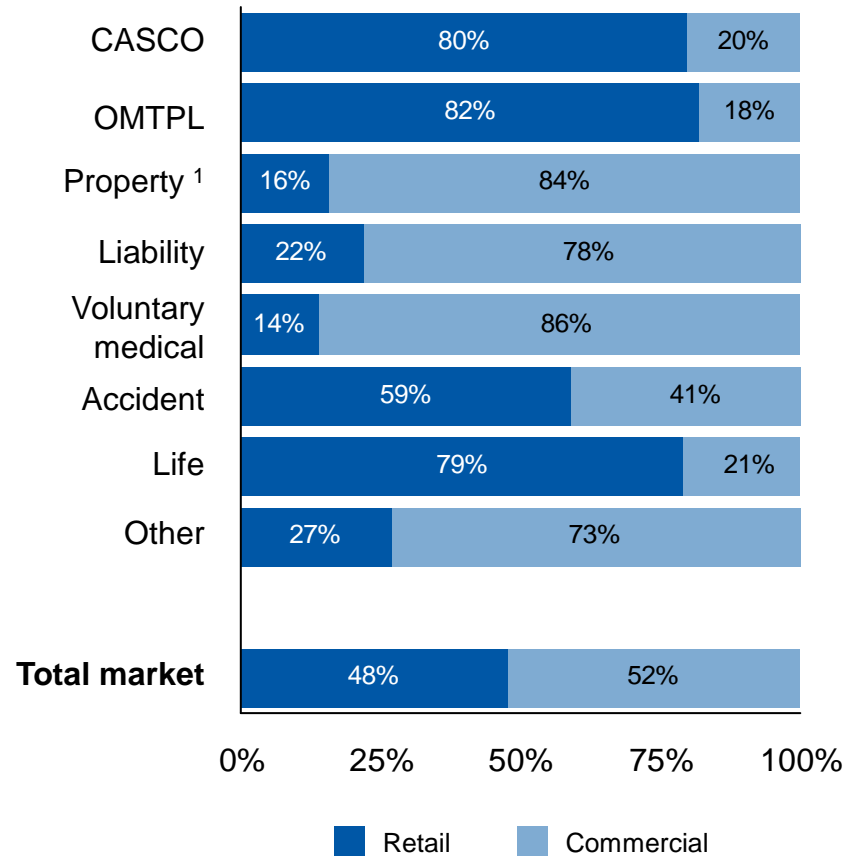
- Channel profitability reflects the product mix of individual channels
- Commercial lines are sold predominantly through offices which explains the high share of office sales in overall profits
- Retail channels which sell predominantly motor products (retail brokers and car dealers) are making a loss

Source: Oliver Wyman product / channel premium and profit pool analysis 2010

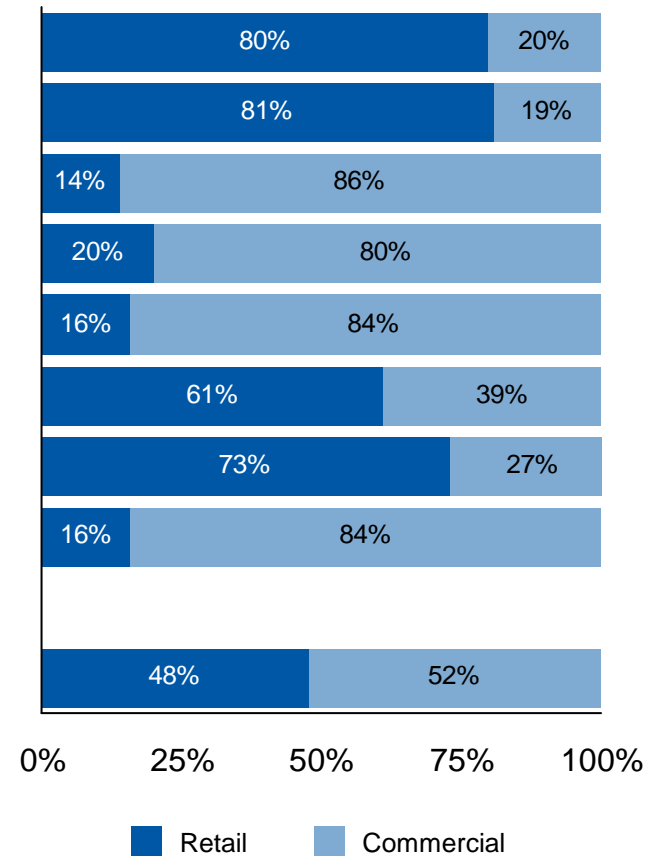
1. Pre-tax profits include full claims cost, acquisition cost and administration cost as well as investment income

## The retail / commercial split remained broadly the same along all business lines

**GWP Retail vs. Commercial**  
FY 2010



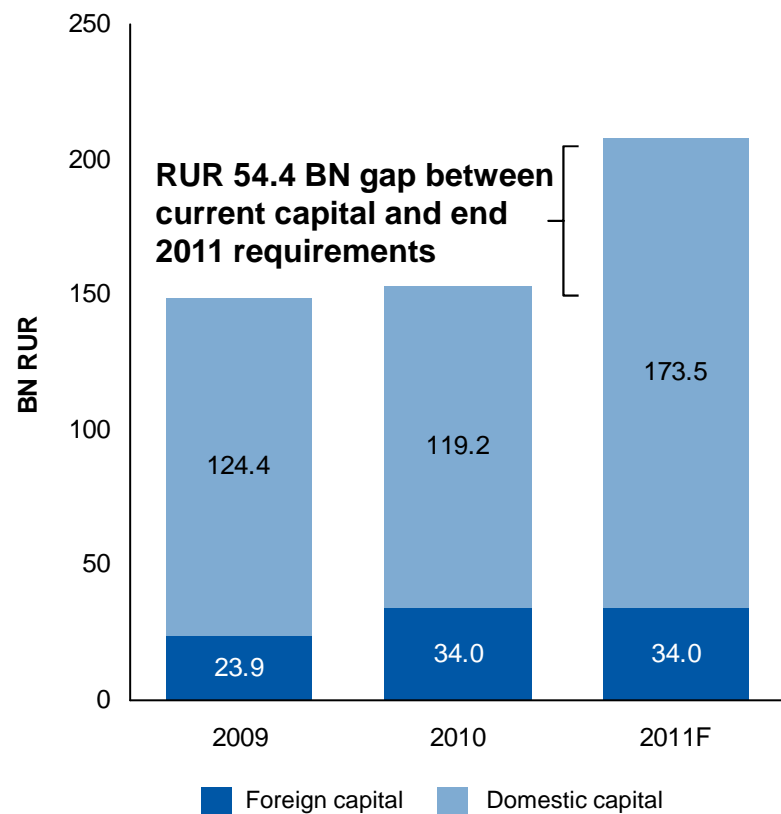
**GWP Retail vs. Commercial**  
FY 2009



Source: Official insurance regulator figures; Oliver Wyman analysis.  
<sup>1</sup> Total property, excluding CASCO.

## The Russian insurance market is currently severely undercapitalized versus new capital requirements that become binding Jan. 2012

### Capitalization of Russian insurance market <sup>1</sup>



### Comments

- As of Feb. 2011, there was a RUR 54.4 BN deficit in Russian insurers' cumulative capitalization versus new requirements coming into force at end of this year
  - Capitalization has grown only 3.3% in 2010, suggesting a lack of ability / intent on the part of current shareholders to invest further in the Russian insurance market
- According to FSSN, as of February 2011, 75% of Russian insurers (approximately 470 companies) do not meet the new requirements
- Maintaining capital adequacy of the current number of insurers, an average of RUR 116 MM per insurer will need to be invested
  - The minimum level of capitalization for an insurer is RUR 40 MM
  - There are more than 270 companies in the market who collected less than RUR 40 MM in GWP in 2010

Source: Official insurance regulator figures; Oliver Wyman analysis

1. 2011F capitalization refers to the capital that the current insurers in the Russian market need to have in aggregate to meet requirements coming into force on 01.01.2012

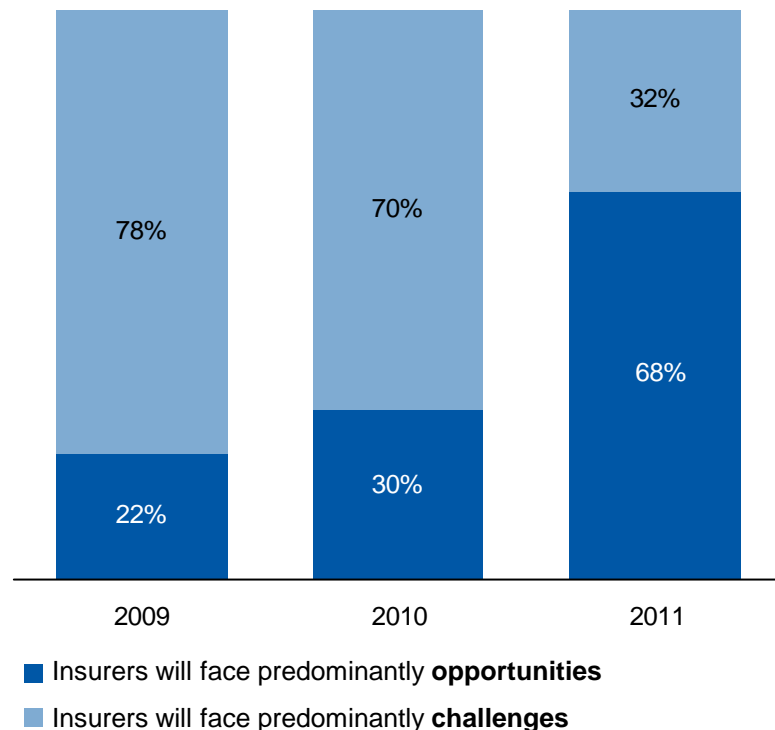
Section 3

## **CEO Outlook for 2011**

### **3.1 Financial performance**

## Russian Insurance CEO pessimism of the last two years has given way to a much more optimistic outlook for the market's development in 2011 and beyond

### Outlook for the Russian insurance sector CEO perspective



Source: Russian Insurance CEO Surveys 2011, 2010 and 2009; Oliver Wyman analysis

#### CEO expectations in January 2009

- Almost 80% of CEOs expected that the financial crisis will create serious challenges for the Russian Insurance market

#### CEO expectations in April/May 2010

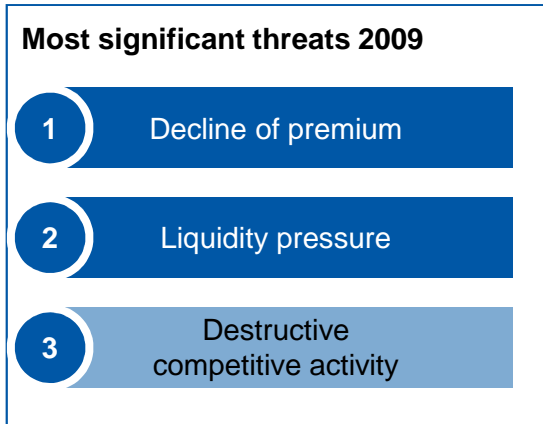
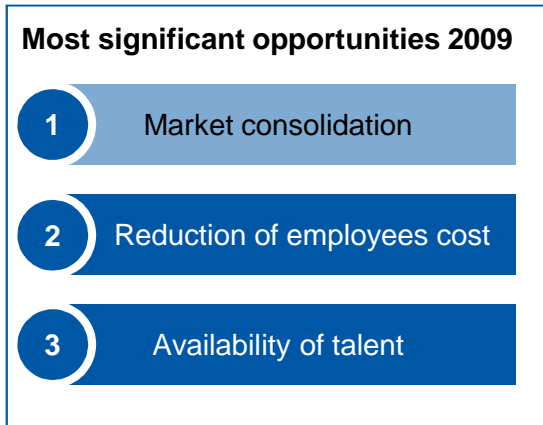
- While more CEOs saw opportunities in the market than at the beginning of 2009, the majority was hesitant or outright pessimistic
  - 52% saw predominantly challenges
  - 18% expected some more crisis fallout
  - Only 30% believed that they can capture the opportunity and score a “relative victory” over competitors

#### CEO expectations in January 2011

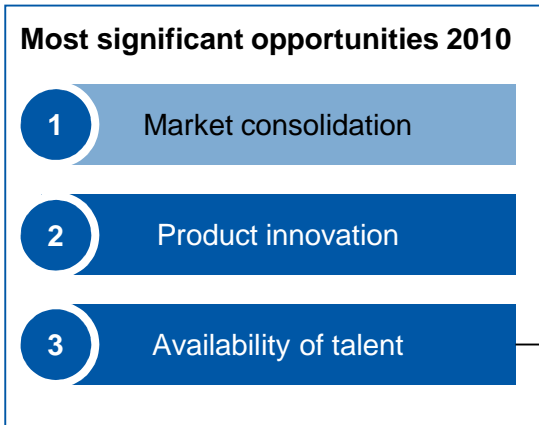
- Almost 70% of CEOs see predominantly opportunities associated with the returning growth
  - Pessimism has finally given way to a more optimistic view of the market
  - However, expectations are that margins remain under pressure

## CEOs see opportunities clearly connected to returning growth and market consolidation whilst destructive competition remains the core threat

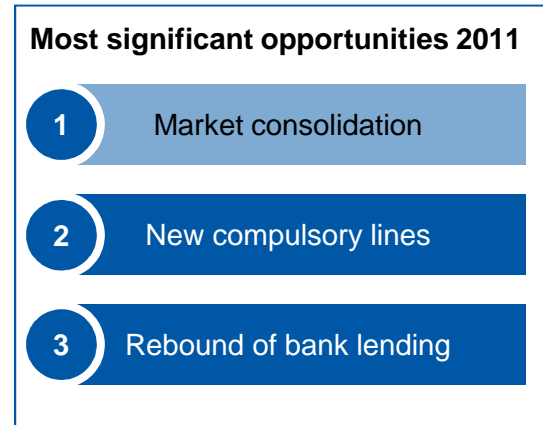
### Opportunities and threats 2009



### Opportunities and threats 2010



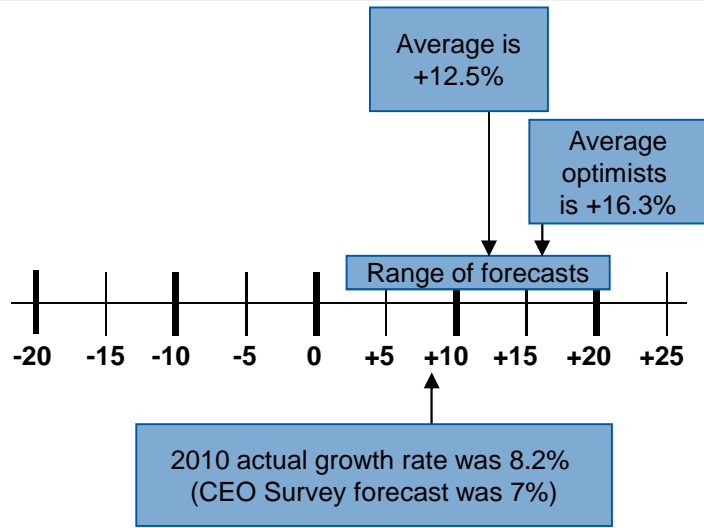
### Opportunities and threats 2011



Source: Russian Insurance CEO Surveys 2009, 2010, 2011, Oliver Wyman analysis

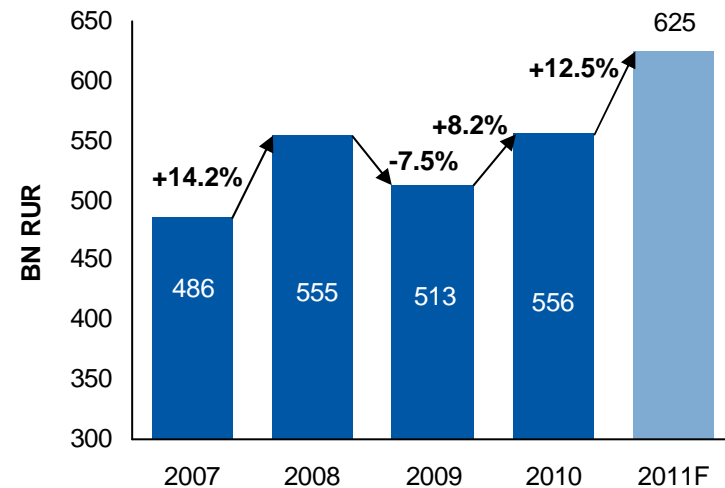
**CEOs expect that the market will return to double digit growth of 12.5%, well above inflation, with optimists expecting growth of about 16%**

**Expected premium volume development in 2011**  
Survey participants' perspective



- Respondents' growth expectations range between 2.5% and 22% growth, a significantly more narrow range than in the 2009 and 2010 CEO Surveys
- Answers average at 12.5% GWP growth
  - Well above expected inflation
  - Optimists expect GWP growth to be above 16% reaching pre crisis levels
- 1H YoY 2011 growth was above 17%, indicating that 2011 may end up closer to the "optimistic estimate"

**Gross written premium development**



- Expectations are that the market is back to double digit growth in 2011 after having returned to 2008 total premium levels in 2010
- Key growth driver is the recovering economy resulting in:
  - Significant increase of new car sales
  - Significant increase in consumer lending and associated credit linked insurance products
  - Improving understanding of the value of insurance among commercial clients

Source: Insurance CEO Survey 2011; Oliver Wyman analysis

## CEOs believe that contrary to premium, margins will not recover in the near term

### Expected profitability development Survey participants' perspective



- Whilst expectations on market profitability was polarized in 2009 and 2010, there is now increasing consensus that the market is just breaking even
- Only 24% of CEOs believe that the market as a whole will be profitable, versus 48% in 2010
- 25% of CEOs do not see profits for 2011

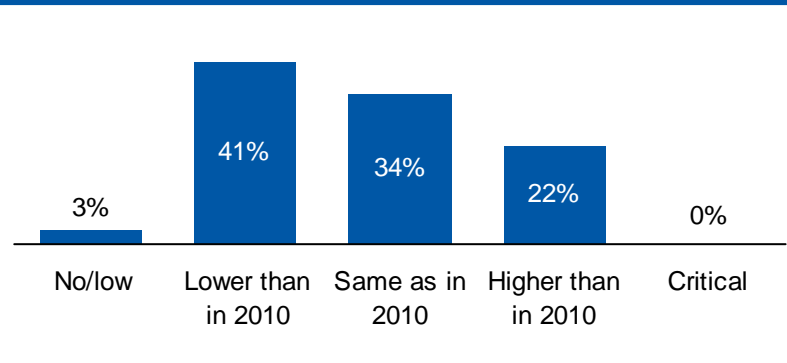
### Interpretation and trend

- The mechanisms of destructive competition are still at work as companies return to pre-crisis behaviours with an almost indiscriminate quest for growth in all major lines of business
  - Ease of liquidity pressure gives cash-flow operators a life line
  - Companies continue to compete on price and commissions
  - Little product/channel innovation visible
- Whilst claims and commission cost are expected to remain at 2010 levels, there is broad agreement that:
  - The pressure on administration cost (salary cost and hiring top talent) is on again and likely to increase in 2011 and beyond
  - The cost of office space will increase driven by strong overall economic growth
- The aggressive cost cutting measures taken in 2009 helped reduce administration cost temporarily but did not:
  - Lead to sustained efficiency improvements
  - Result in strategic differentiation

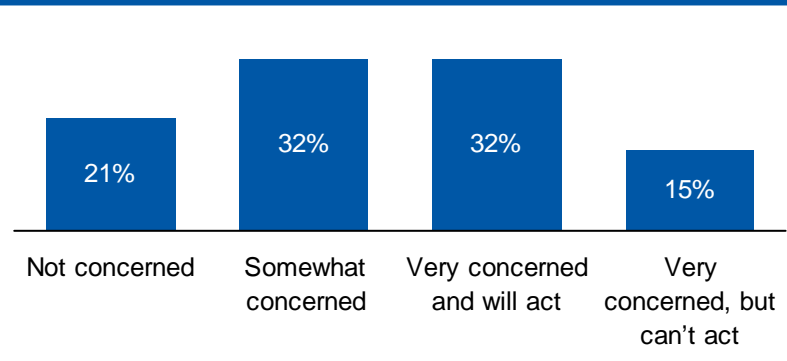
Source: Insurance CEO Surveys 2011,2010 and 2009; Oliver Wyman analysis

## CEOs expect that returning growth eases the pressure on liquidity, however, almost 50% of insurers remain very concerned about their liquidity position

### Pressure on insurers' liquidity in 2011 Survey participants' perspective on market



### Concern over own liquidity in 2011 Survey participants' perspective on own company



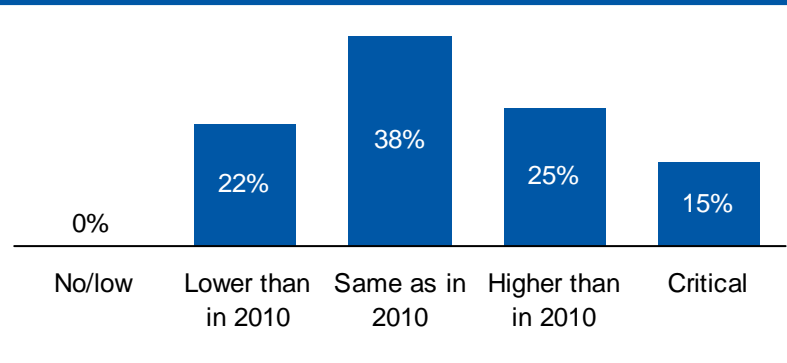
### Interpretation and trend

- Liquidity pressure due to contracting premium volume in 2009 and growth below inflation in 2010 has been the key driver behind destructive competitive behavior
- The expected above inflation growth of 12.5% for 2011 will likely ease the pressure on liquidity, but will not remove it entirely
- CEOs see liquidity for the market as a whole no longer as critical with opinions split between pressure remaining at 2010 levels and pressure easing versus 2010
- However, 47% of respondents remain very concerned about their own liquidity position:
  - 32% of those feel that they are in a position to act and resolve their issues
  - But 15% feel they are unable to act
- Given that the majority of Insurers did not meet the new capitalisation requirements for January 2012 in Q1 2011 it is clear that shareholders will have to inject fresh capital
- With liquidity an issue for almost half of the Russian insurers, destructive competition is likely to stay with adverse impact on margin recovery

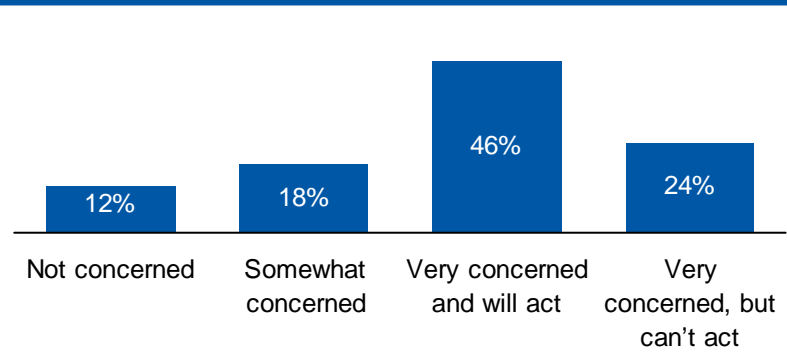
Source: Russian Insurance CEO Survey 2011 and follow up interviews; Oliver Wyman analysis

## Combined ratios are not expected to improve versus 2010 and more than 70% of respondents are very concerned about their underwriting margin development

### Pressure on insurers' combined ratio in 2011 Survey participants' perspective on market



### Concern over own combined ratio in 2011 Survey participants' perspective on own company



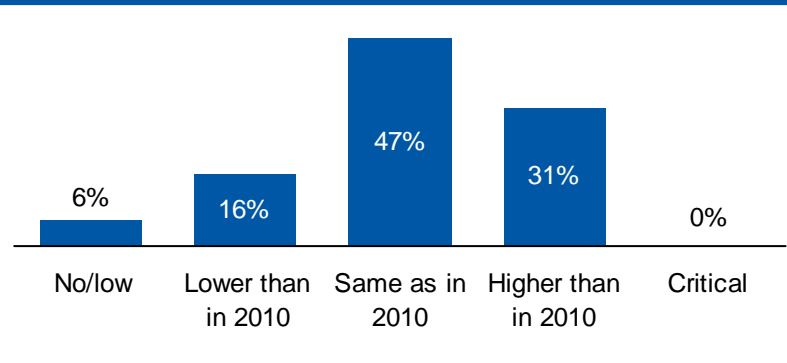
### Interpretation and trends

- Russian insurance CEOs do not expect double digit growth will be followed by improved underwriting results
  - The broad majority of survey respondents (78%) expect that combined ratios will remain at 2010 levels or become worse
  - 15% expect that the situation will become critical for the market as a whole
- This is reflected in the outlook which CEOs gave for their own company's performance
  - 71% are very concerned about their underwriting results
  - Of those 47% think that they will be able to act and get the issue under control
  - However, almost 25% of insurers do not see how they can act at all, implying that a quarter of the insurers participating in the survey expect to make an underwriting loss for 2011
- Analysis shows that CR pressure is due to:
  - Claims cost remaining at 2010 levels
  - Commissions remaining at 2010 levels
  - Increasing administration cost due to raising salaries and office rental cost

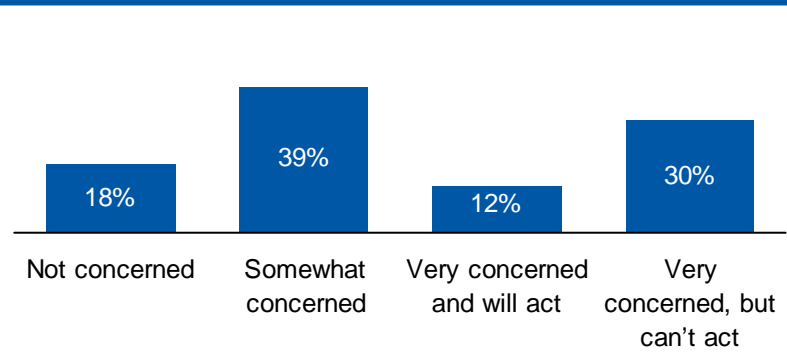
Source: Russian Insurance CEO Survey 2011 and follow up interview; Oliver Wyman analysis

## Whilst the view on investment results remains positive, survey participants acknowledge that they contribute much less to overall results than in mature markets

### Pressure on insurers' investment result in 2011 Survey participants' perspective on market



### Concern over own investment result in 2011 Survey participants' perspective on own company



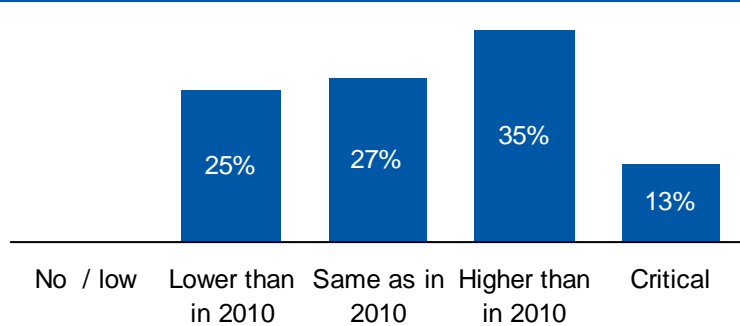
### Interpretation and trends

- Russian Insurance CEOs expect investment results to be in line with 2010 or even better, reflecting the economic outlook and a belief that the global financial crisis is over or at least contained<sup>1</sup>
- However, investment results have a comparably small contribution to overall results given that:
  - Reserves of Russian insurers are low compared to insurers in more mature markets
  - Assets are often “strategic assets” of the shareholder which cannot be liquidised and cannot be used to underwrite risk against
  - This is reflected by the fact that almost 1/3 of respondents say that they are concerned about investment results for 2011 “but cannot act”
  - Regulations restricts investment to domestic markets resulting in significant volatility of returns
- New capitalisation requirements will not change this situation for larger insurers as the new regulation addresses only the minimum capitalisation irrespective of insurer’s size

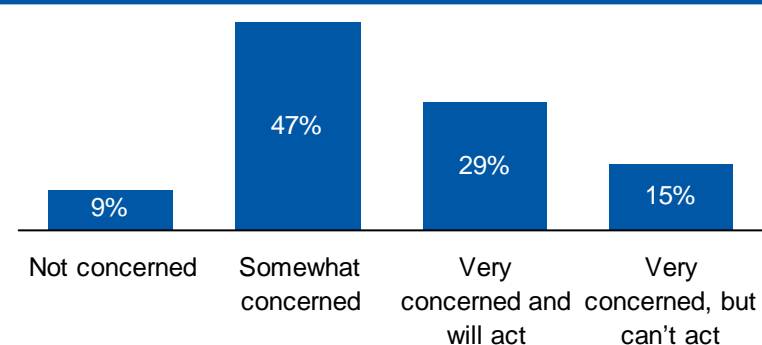
Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis  
 1 Apparently discounting adverse development scenarios in the European Sovereign crisis

## Loss ratios are expected to remain at 2010 levels or even increase versus 2010

### Pressure on insurers' loss ratio in 2011 Survey participants' perspective on market



### Concern over own loss ratio in 2011 Survey participants' perspective on own company



### Interpretation and trends

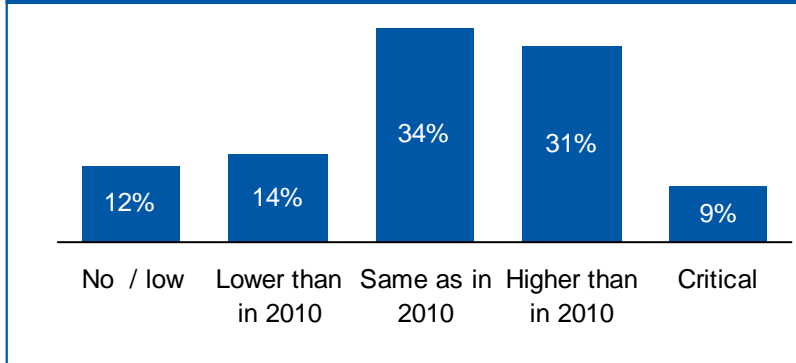
- Russian Insurance CEOs expect that loss ratios remain at 2010 level or even increase versus 2010
- Reported Q1 2011 pay-out data already indicate that payout growth is picking up again versus premium growth
- Underlying inflation in the high single digits implies that cost of claims will trace premium growth closely, even discounting claims inflations
  - Voluntary Medical Insurance suffers from shortage of medical infrastructure and an inability to control cost for many insurers, implying that claims in VMI will likely outgrow inflation
  - Insurers continue to have little control over spare parts and repair cost, often even lacking authoritative statistics and benchmarks
  - Entanglement of repairs with car dealer sales (who often expect more claims volume than they provide premiums) makes improvements of claims structurally cost difficult
  - Fraud and process inefficiency remain a major issue in the market

Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## Acquisition cost ratios are expected to remain at 2010 levels or even increase with insurers not daring to address the high commissions commanded by intermediaries

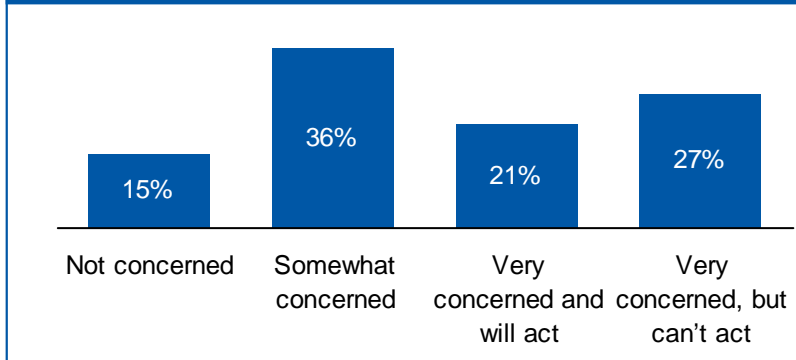
### Pressure on insurers' acquisition ratio in 2011

Survey participants' perspective on market



### Concern over own acquisition ratio in 2011

Survey participants' perspective on own company



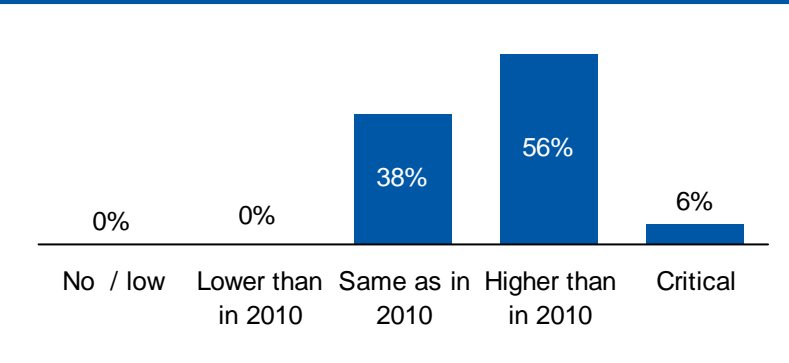
### Interpretation and trends

- Russian CEOs to not expect acquisition cost to come down compared to 2010, quite on the contrary:
  - Almost ¾ of participants expect acquisition cost to be at 2010 levels or above
  - For many, growth has traditionally been bought by paying high commissions to intermediaries
  - Some have started to invest in improving direct and/or owned channels, but success has not yet materialised at a meaningful scale
  - Cost for marketing are returning to pre crisis level and “marketing noise” is increasing again as insurers increase their marketing activities
- Almost half of the survey participants are very concerned about their company's acquisition cost:
  - About 20% believe that they can address the issue for example through investing into direct or owned channels
  - However, almost 30% do not see an opportunity to act, fearing loss of top line with any action they may take

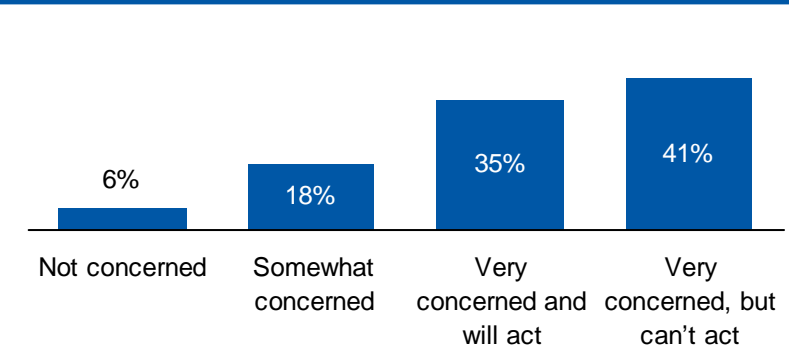
Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## Administration cost ratios are expected to increase and concern about raising cost of salaries and office space is paramount

### Pressure on insurers' admin ratio in 2011 Survey participants' perspective on market



### Concern over own admin ratio in 2011 Survey participants' perspective on own company



### Interpretation and trends

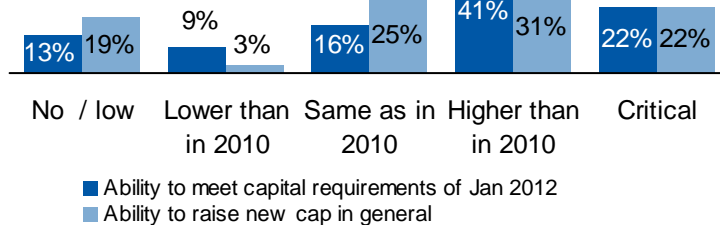
- Russian CEOs felt already in 2010 that with the rebounding economy, salary expectations of employees and rents for office space quickly returned to pre-crisis levels
  - This development is seen as an irreversible trend and there is common belief that salaries will rise at least in line with inflation
  - Only few insurers have been able to negotiate longer term favourable rent agreements for office space during the crisis
- Most insurers introduced rather heavy handed anti-crisis measures in 2009 which did not lead to structural efficiency improvements and also did not lead to strategic differentiation
- Most insurers did not invest in structural efficiency improvements in 2010, still struggling to stay liquid and survive the destructive competition
  - Making structural efficiency improvements is costly and benefits materialise usually only a year after starting implementation
  - In many instances, efficiency improvements would require significant IT investments which companies are not ready to make, reflected by the fact that 41% of insurers say they “cannot act”

Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## The new minimal capital requirements which become effective in January 2012 are seen by respondents to affect the market more than themselves

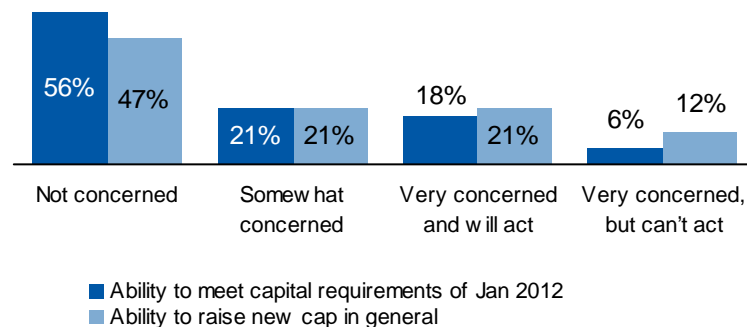
### Pressure on insurers' ability to meet new capital requirements by January 2012

Survey participants' perspective on market



### Concern over own capital position in 2011

Survey participants' perspective on own company



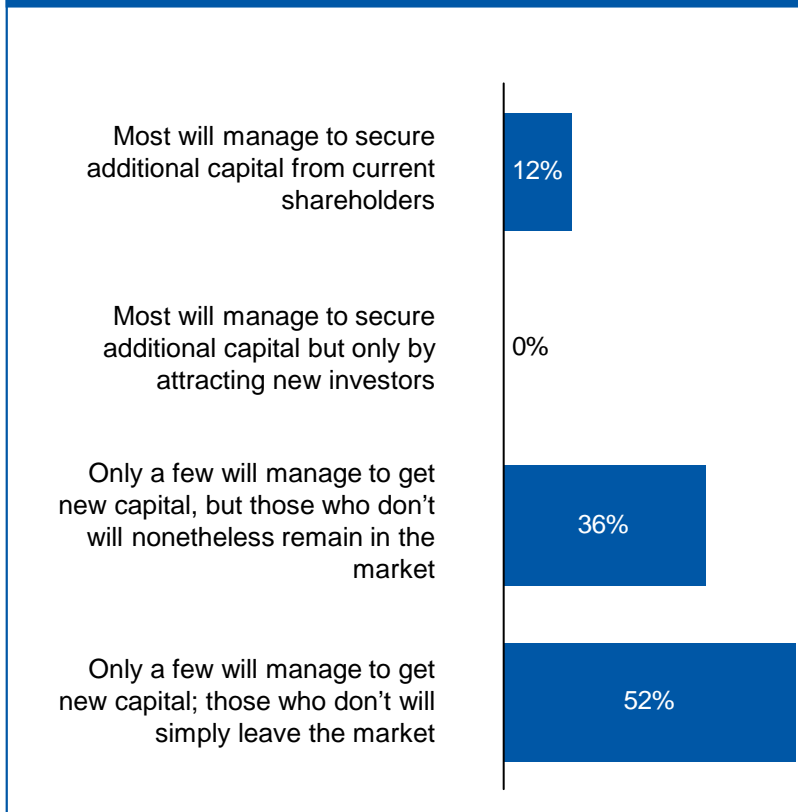
### Interpretation and trends

- Russian Insurance CEOs expect that raising capital will be easier than in 2010, however they acknowledge that:
  - Investor sentiment abroad has turned against Russia versus the other BRICs
  - Large foreign insurers have scaled back their investment into their Russian operations
  - Shareholders are mostly unwilling to make major investments beyond what is required by the regulator
- Nonetheless, 25% of survey participants are very concerned about their ability to meet the new capital requirements. This is fewer than one would expect given that:
  - As much as 75% of insurers (some 470 companies) did not meet the new capital requirements in Feb 2011
  - Some RUR50bn of fresh capital is required
  - Some 150 insurers have less premium than the new required minimum capitalisation
- Since historically sound insurance companies are overrepresented in the survey, the results may be reflecting the majority of premium rather than the number of insurers

Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## Survey respondents do not believe that companies not meeting the new capital requirements today will be able to raise the necessary capital by year end

### What do you believe will happen in 2011 to those insurers who are currently undercapitalized versus the Jan 2012 capital requirements?



### Interpretation and trends

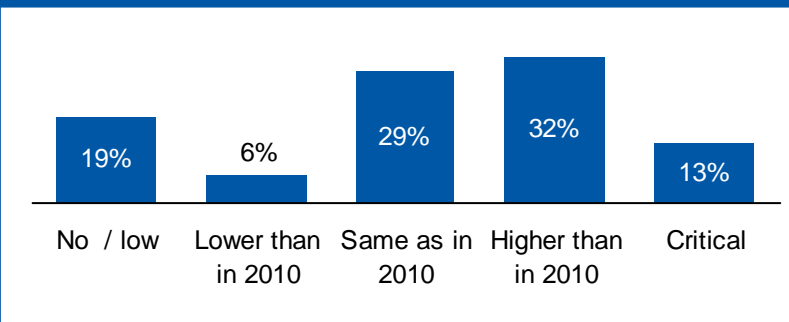
- There is strong consensus among Russian Insurance CEOs that those companies which do not meet the new capital requirements today, will not be able to raise the required capital from either investors or shareholders
- However, more than 1/3 believe that many of these companies will continue to exist (at least for some time) without meeting the new capital requirements
- There is a general concern that the responsible authorities do not have the capacity to deal with a violation of the new capital rules of several hundred insurers
  - Even taking several 10 companies under administration, is seen as “physically impossible”
  - CEOs thus expect there will be “grace periods” extended to insurers to improve their capital position

Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## Improved cash-flows have eased the pressure on servicing debt

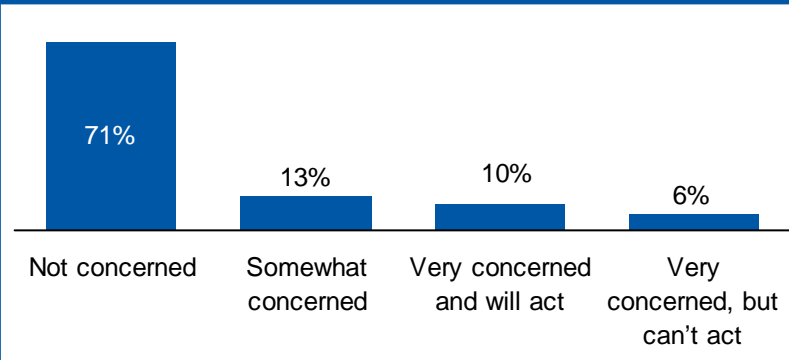
### Pressure on insurers' ability to service debt in 2011

Survey participants' perspective on market



### Concern over own ability to service debt in 2011

Survey participants' perspective on own company



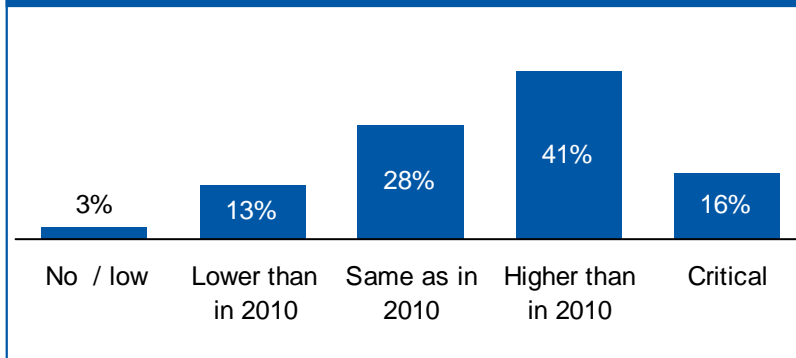
### Interpretation and trends

- Russian Insurance CEOs believe that many insurers have still struggle with servicing their company's debt
  - About 1/3 say that pressure on insurers to service their debts has increased versus 2010, despite improved cash-flows
  - 13 % of CEOs say that debt has reached critical levels
- More than 70% of respondents are not concerned about their own ability to service their existing debt
  - 16% are concerned about servicing their own debt and only 6% say that they do not see how they can address the situation

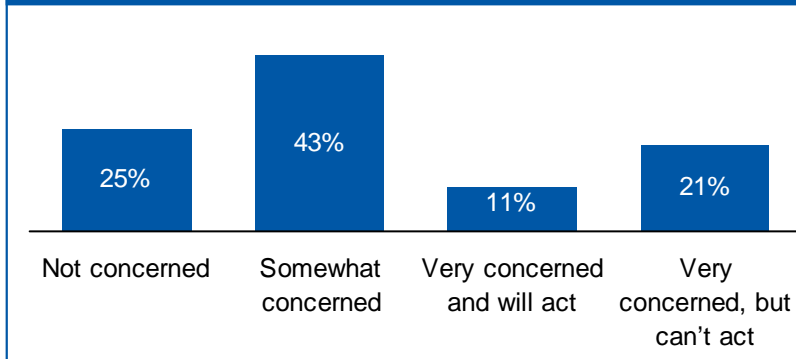
Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

## Insurers' ability to finance projects has improved significantly versus 2010, but some concerns versus own company abilities remain

### Pressure on insurers' ability to finance projects Survey participants' perspective on market



### Concern over own ability to finance projects Survey participants' perspective on own company



### Interpretation and trends

- There is a general expectations in the market that leading insurers will now start to make structural improvements to their operations
  - Most likely led by top 10 players and selected well financed (foreign owned) second tier players
  - Aiming for achieving sustainable advantages in:
    - Operational efficiency (retail)
    - Client / distribution partner service levels
    - Own distribution channels
    - Core technical skills (underwriting, pricing and claims)
- We have seen this trend start in Q3 2010 with an increased demand for our consulting services
  - Business strategy and investor strategy
  - Business Architecture and operations / IT
  - Product / channel innovation

Source: Russian Insurance CEO Survey 2011 and follow up interviews, Oliver Wyman analysis

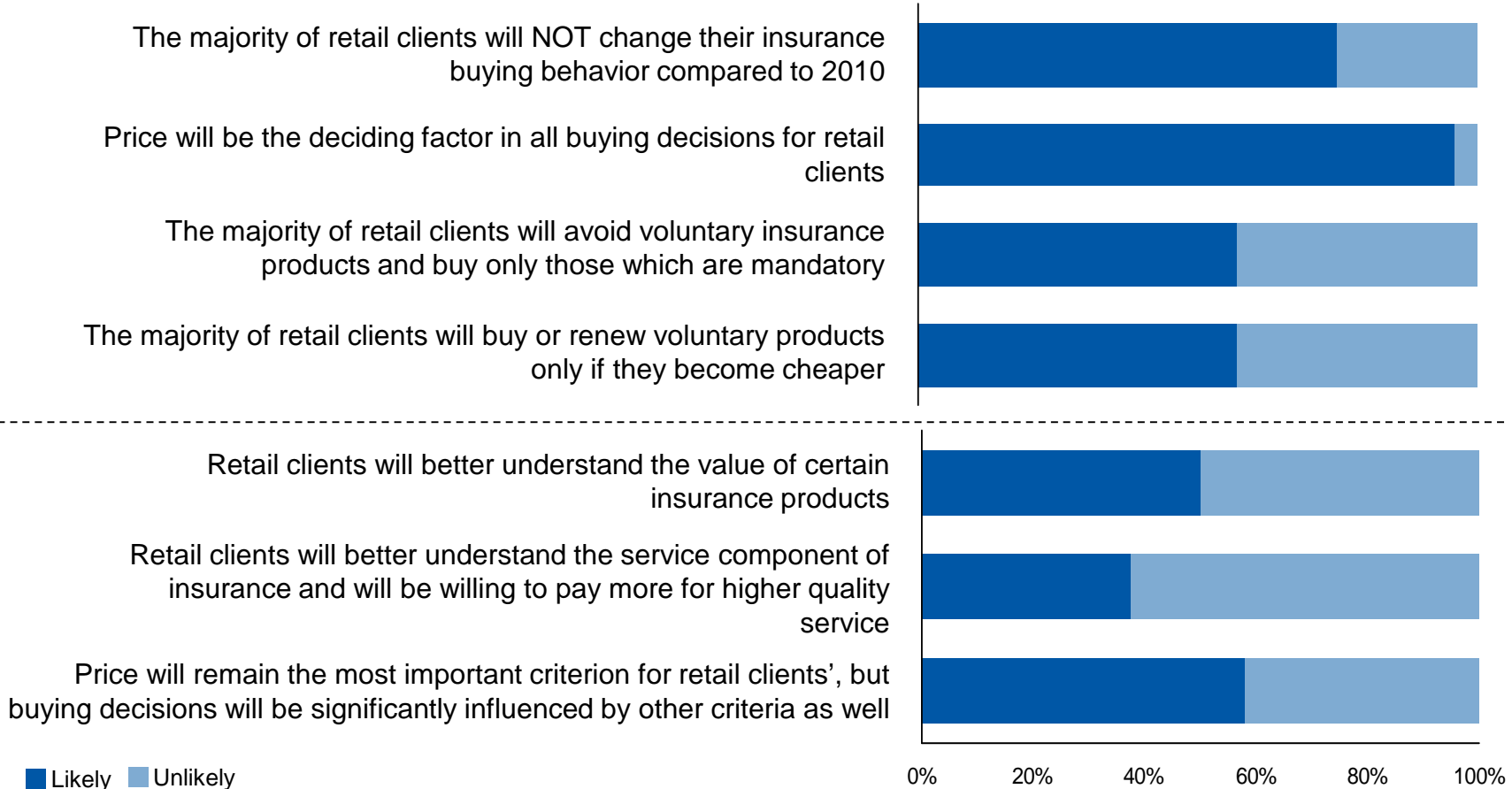
Section 3

# **CEO Outlook for 2011**

## 3.2 Customer behaviour

# The majority of CEOs do not expect a significant change in retail customer buying behavior, saying that customers will continue to chose predominantly on price

How do you think retail clients will behave in terms of their attitude towards insurance and their buying behavior?

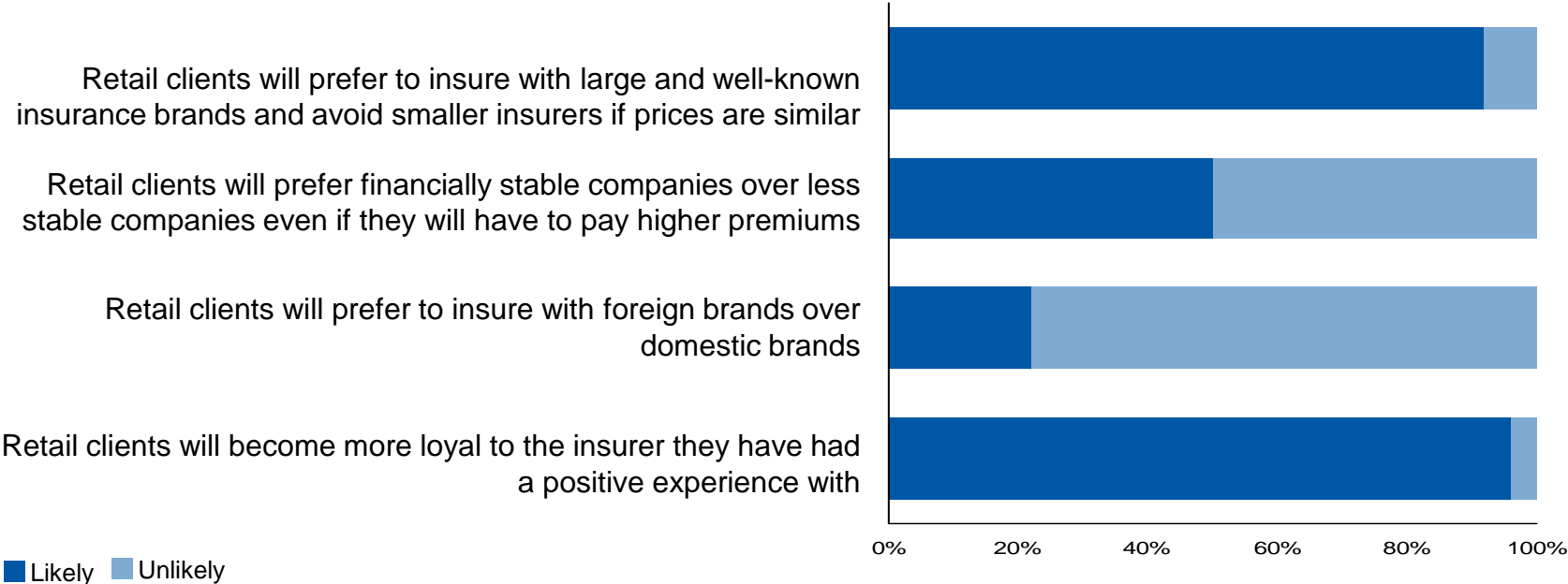


**Recent interviews indicate that this wisdom is questioned by an increasing number of medium and small innovative insurers who see an increasing number of financially literate retail customer**

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## The majority of CEOs believe that being large is a key advantage with retail customers condition that one can provide a good services experience

How do you think retail clients will behave in terms of their attitude towards insurance and their buying behavior?

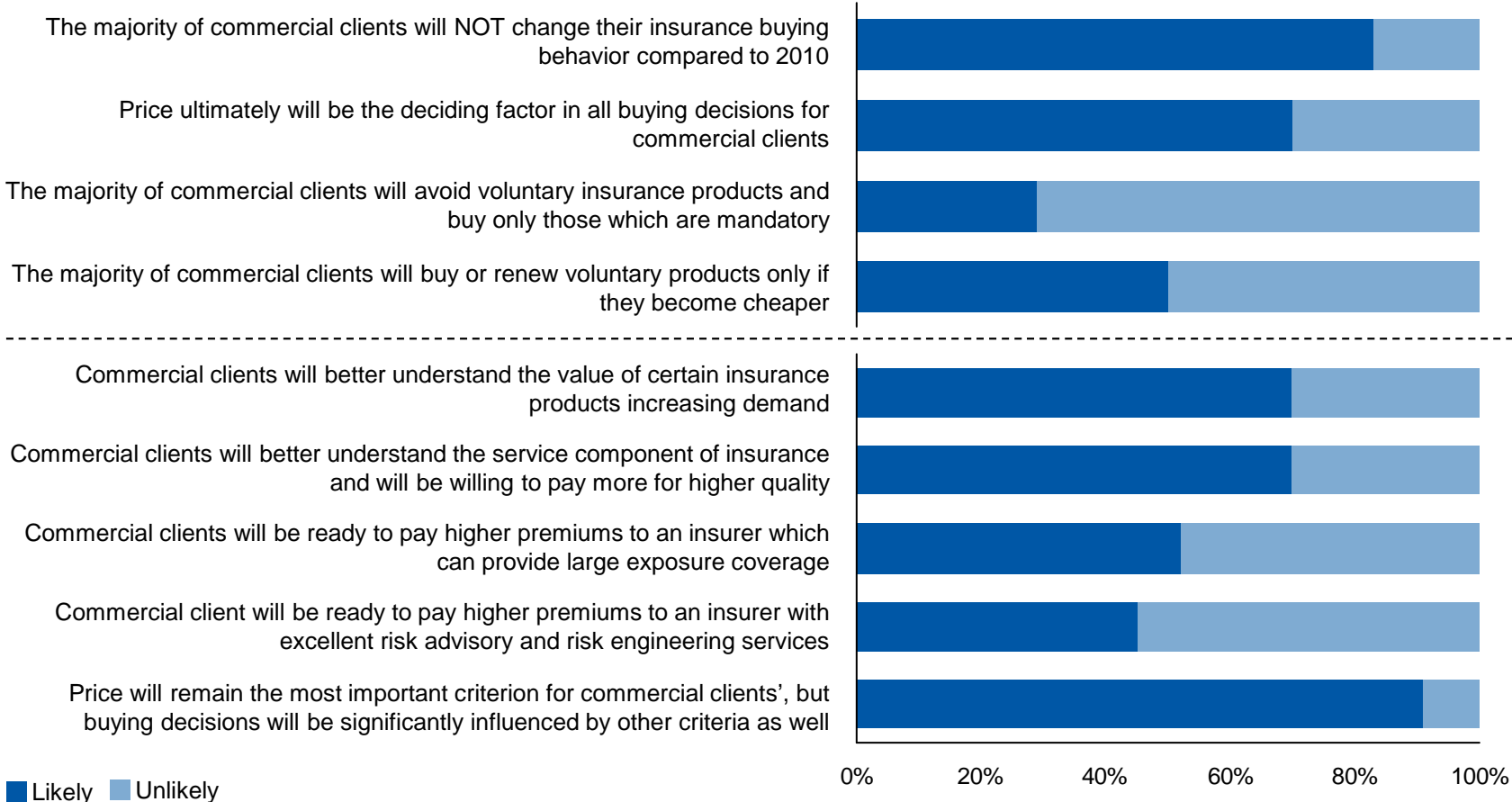


**Service quality and quick turn around of claims is a key strategic differentiator in the retail segment and “financial stability” is increasingly seen as important by customers**

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

# The majority of CEOs do not expect a significant change in commercial clients buying behavior, but see an improving understanding of insurance economics

How do you think commercial clients will behave in terms of their attitude towards insurance and their buying behavior?

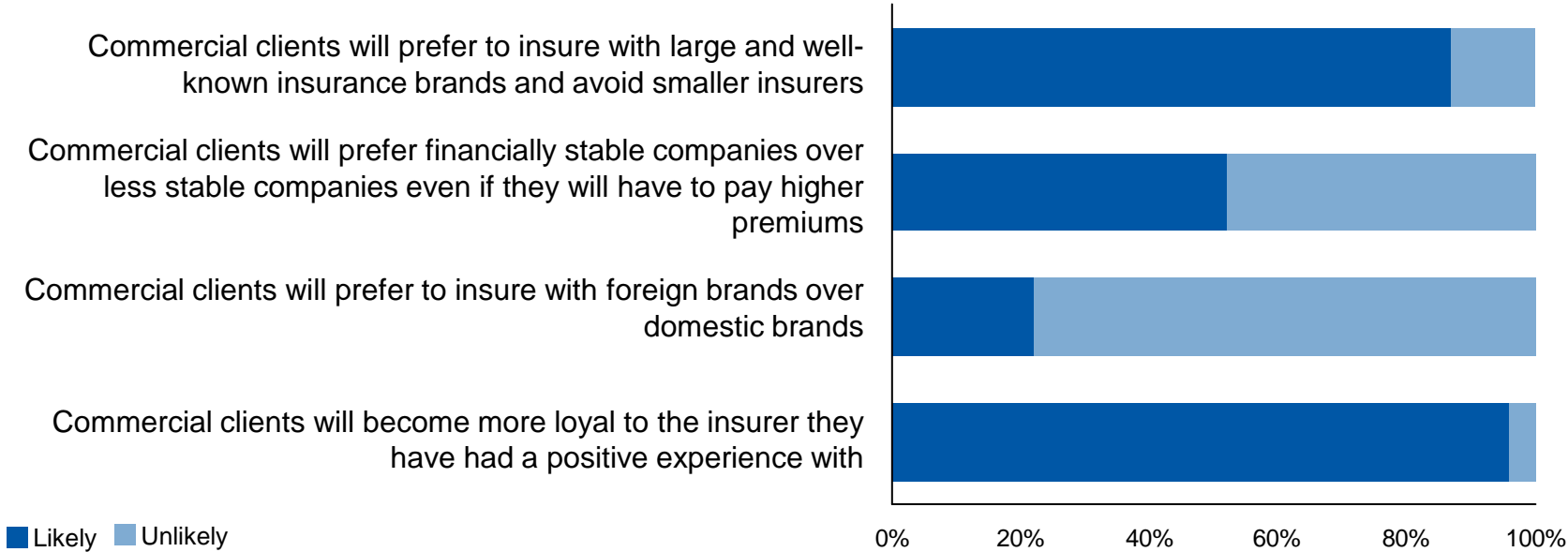


**Commercial clients are becoming more sophisticated insurance buyers, looking for large and well rated capacity and value added services**

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

# Being large is a key advantage with commercial clients and service quality is key for business retention

How do you think commercial clients will behave in terms of their attitude towards insurance and their buying behavior?



**Service quality, size and perceived financial stability are key strategic differentiators with commercial clients but foreign insurers seem not to enjoy advantages**

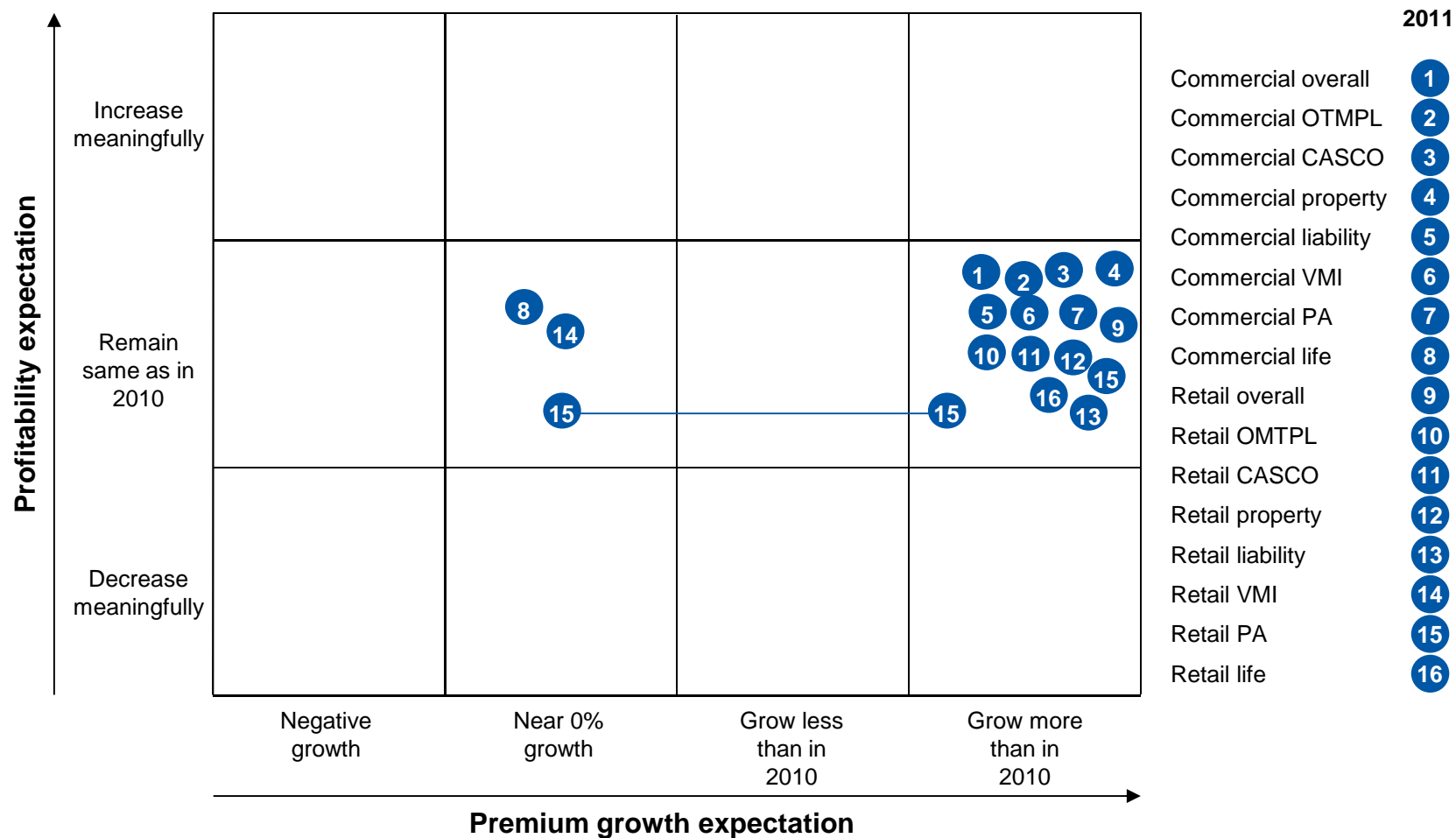
Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

Section 3

# **CEO Outlook for 2011**

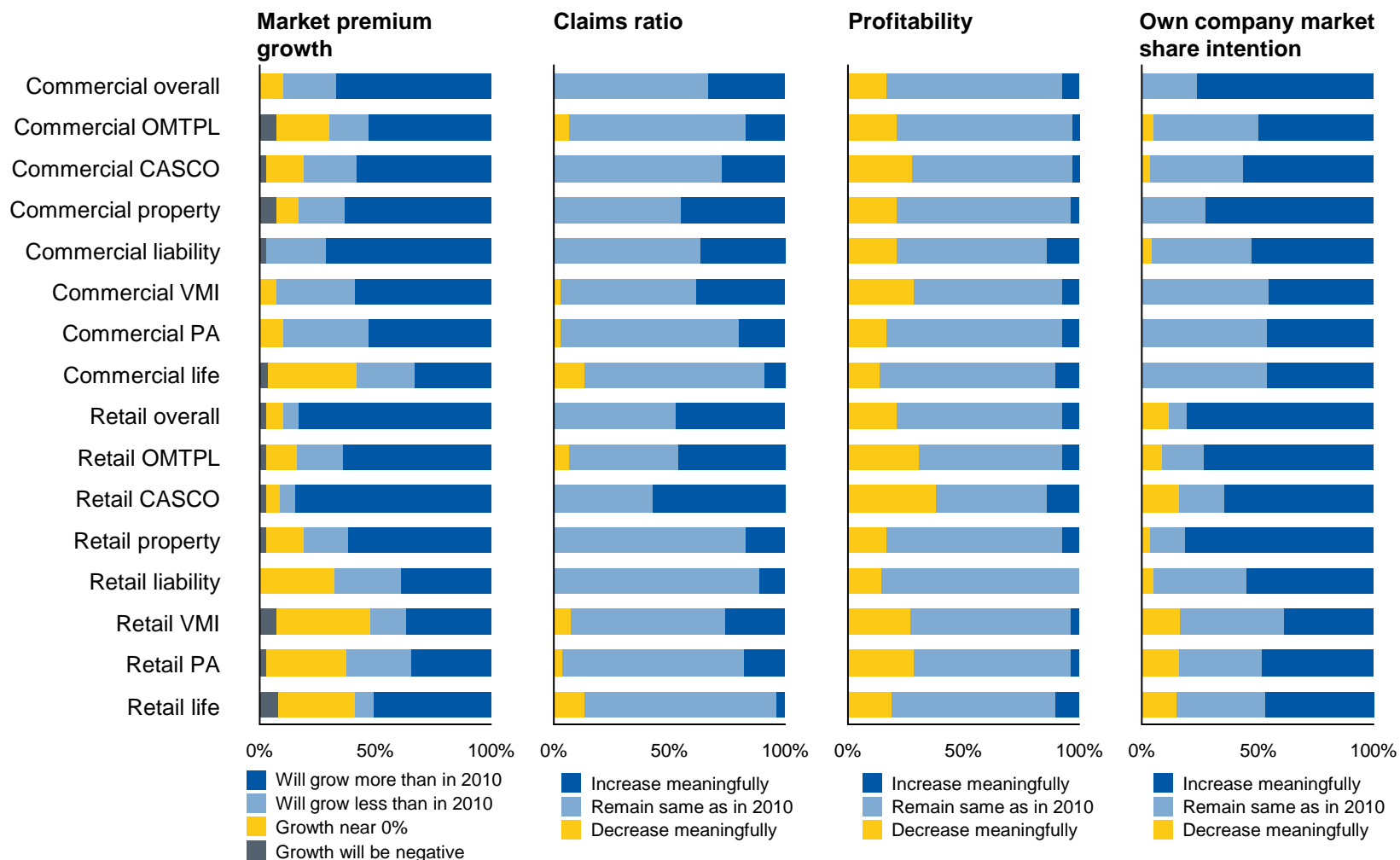
## 3.3 Product performance

# CEOs expect growth in nearly all business lines with profitability remaining at 2010 levels



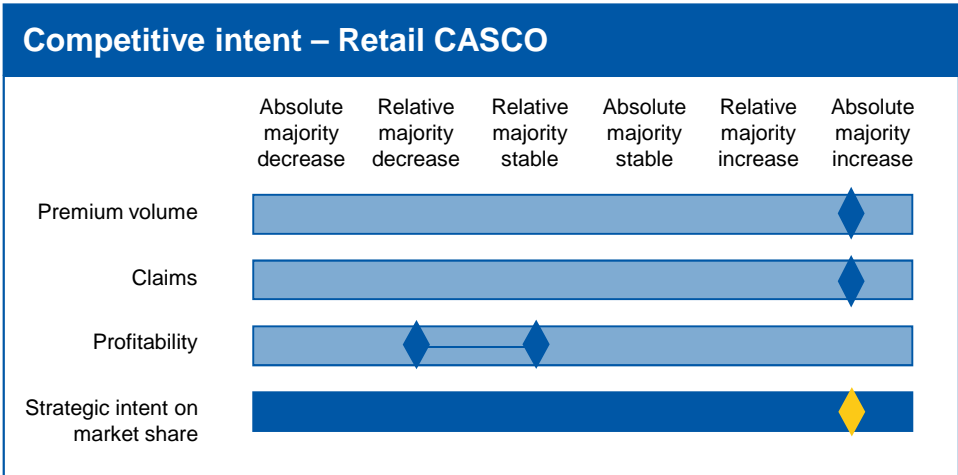
Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

**Synthesis of survey results shows that the predominant strategic intent is to go after growth and accepting the downside of eroding profitability**

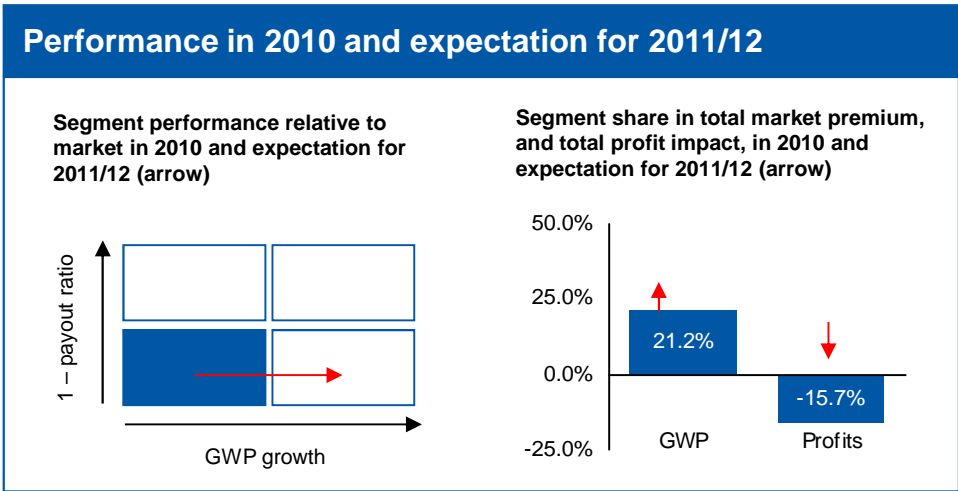


Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

# Almost all players intent to grow in Retail CASCO putting further pressure on the margins in this important insurance market segment



- ### Interpretation and trends
- Premium volume is expected to increase with the economic recovery and the steep increase in sales of new branded cars
  - Claims are expected to increase, because of inflation, absence of deductibles and spare parts prices remaining high (2009 RUB devaluation was priced in but RUB appreciation effect has not been fully shared with insurers)
  - While opinion on profitability impact is split between stable and declining profitability, the general strategic intent to grow market share in Retail CASCO indicates high margin pressure
  - For 2011/12 CASCO will likely outgrow the market average growth but will remain overall unprofitable in the near future, drawing down the overall results of the retail segment



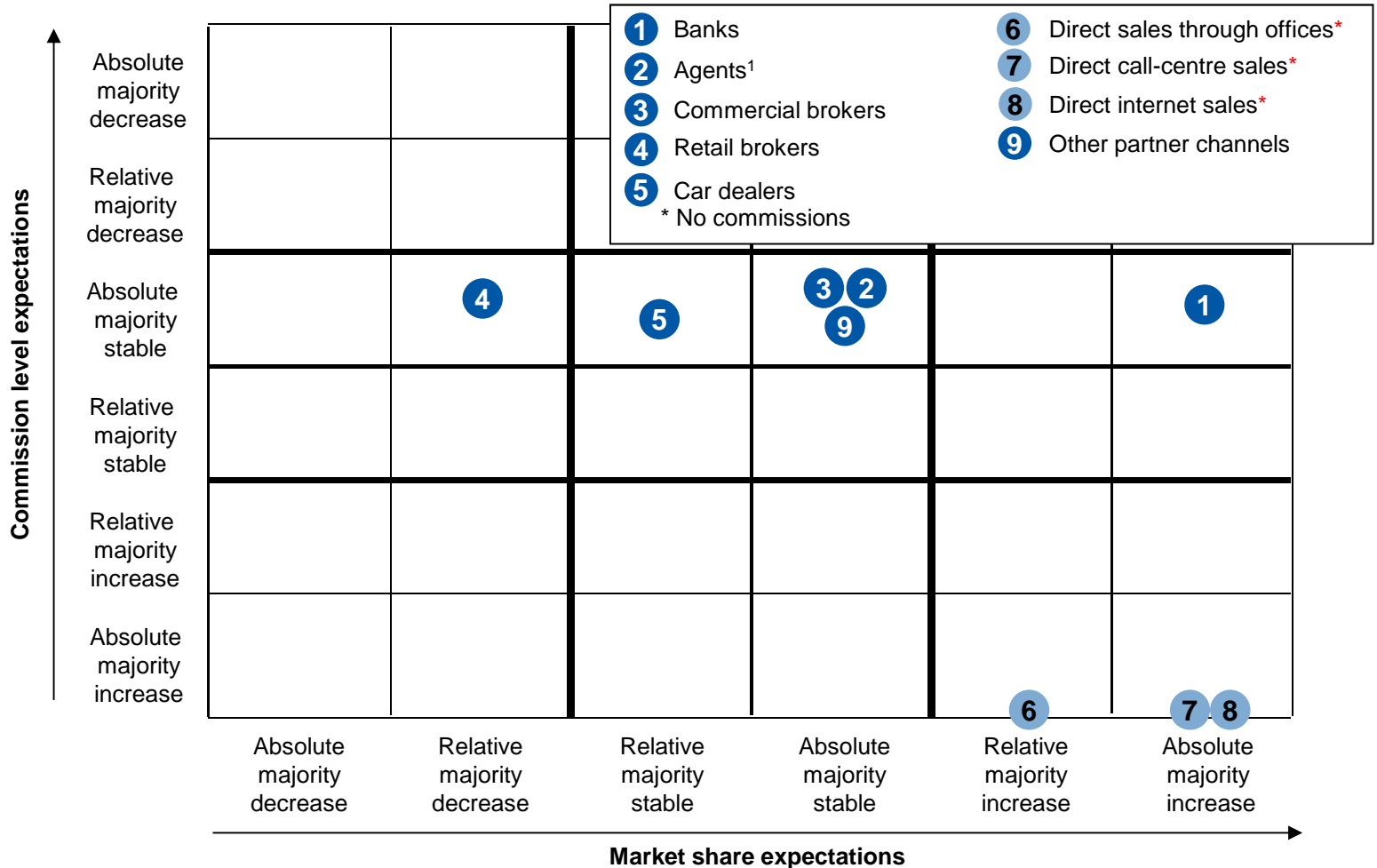
Source: Russian Insurance CEO Surveys 2011, 2010; Oliver Wyman analysis  
 1: Detailed results for all lines of business split by commercial and retail are available on a channel / product level

Section 3

## **CEO Outlook for 2011**

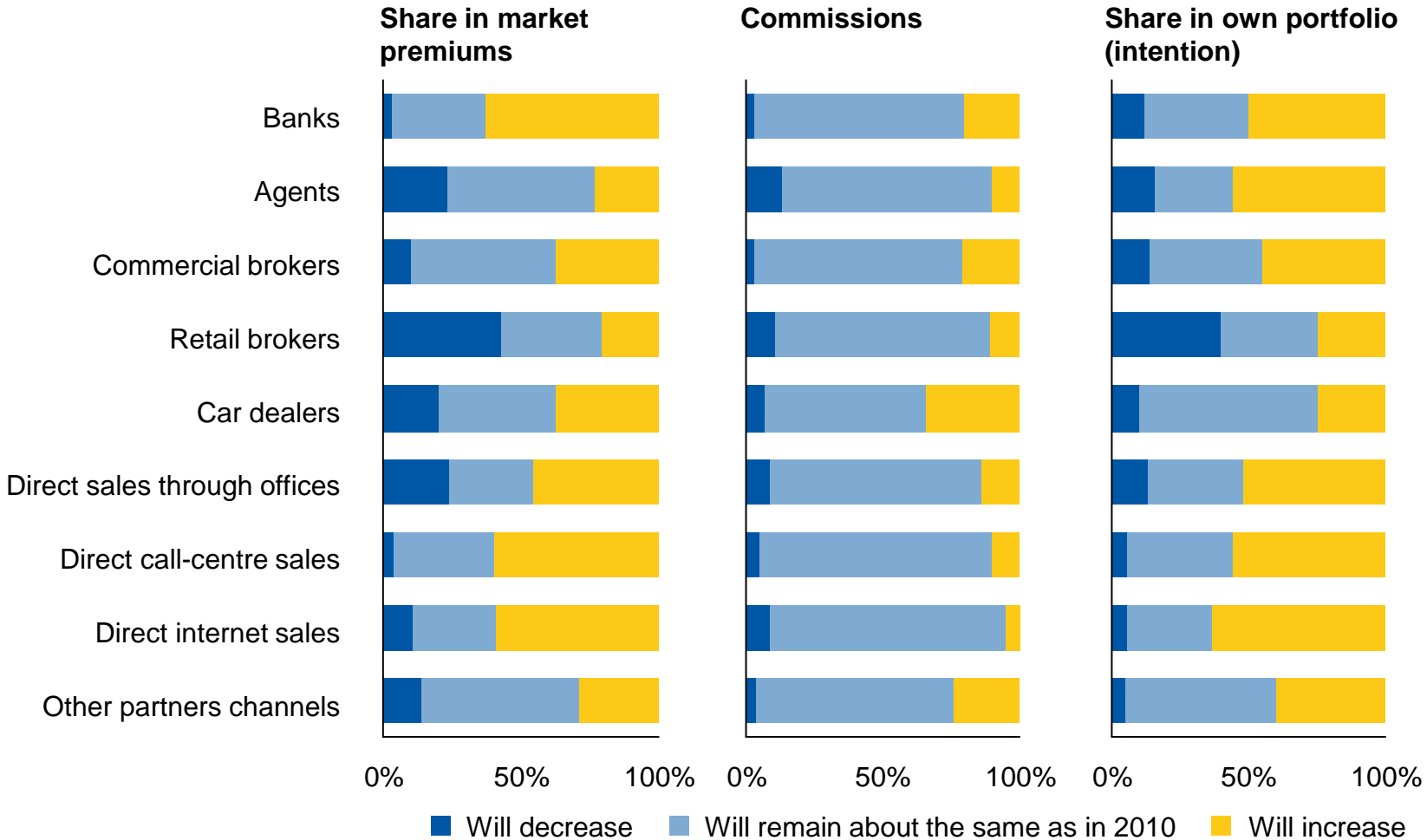
### **3.4 Distribution and channel development**

# CEOs expect that the bank and the direct channels will outgrow the other distribution channels



1. "Agents" refers to individual agents (physical entities), excluding other intermediaries such as brokers  
 Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

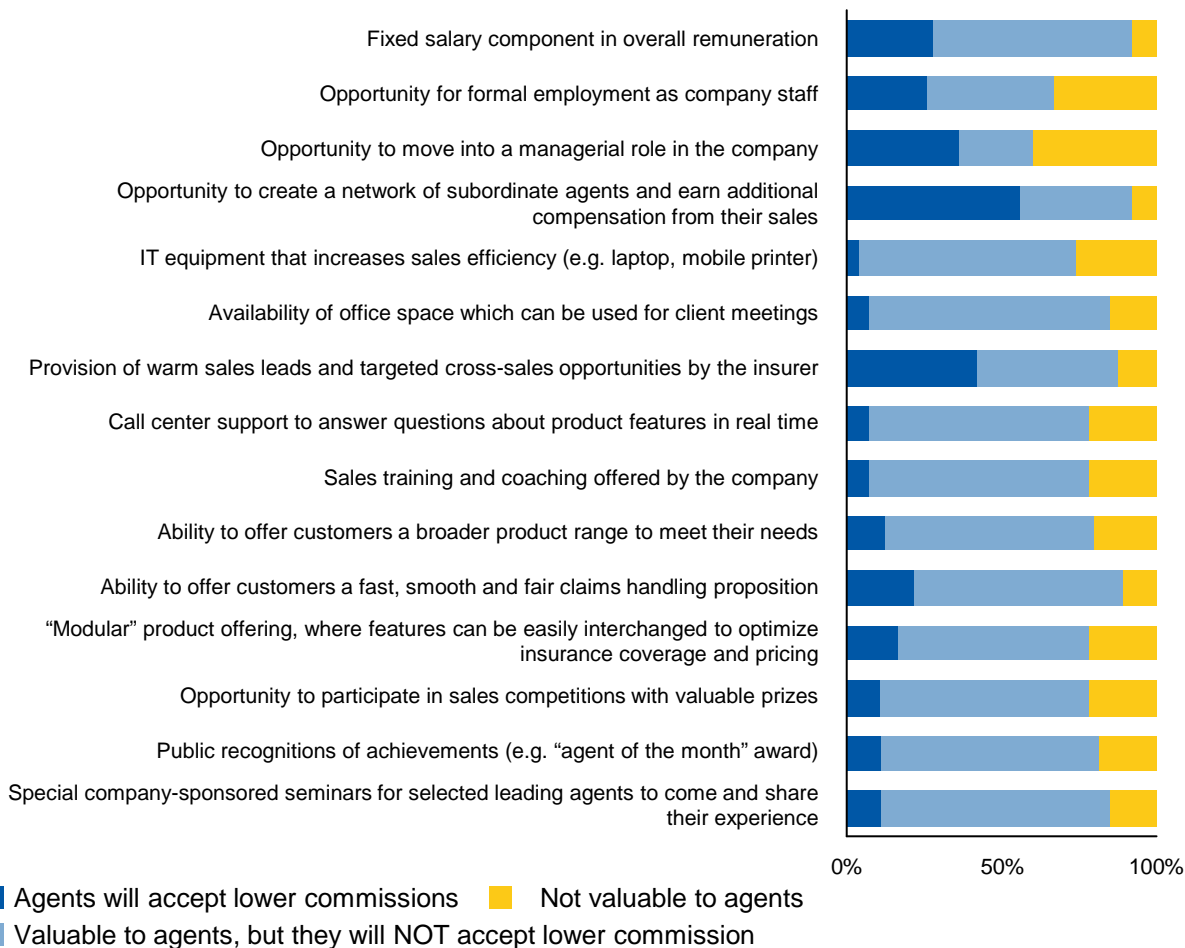
# CEOs seek growth in direct channel, agent capacity and banks and expect that commissions will remain high in all channels



Source: Russian Insurance CEO Survey 2011; Oliver Wyman analysis

## Insurance CEOs do not believe that the typical insurance sales agent is open to structural reform

### For which benefits will agents agree to “pay for” by accepting lower commissions?



- The typical Russian sales agent is multi tied jealously guards his client base
- Survey respondents do not believe that agents would trade in part of their high commission for sales enabling services
- ▶ ▪ However, they believe that agents would accept lower commission for direct provision of larger volumes through
  - Subordinate agents
  - Provision of leads
- Given the demographic issues in the current agent networks, companies should consider alternative forms of network organisation

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## CEOs see direct insurance as a channel rather than as a stand alone business model and see a number of hurdles for it to become an immediate success story

Which of the following statements with respect to direct insurance in Russia would you agree with?

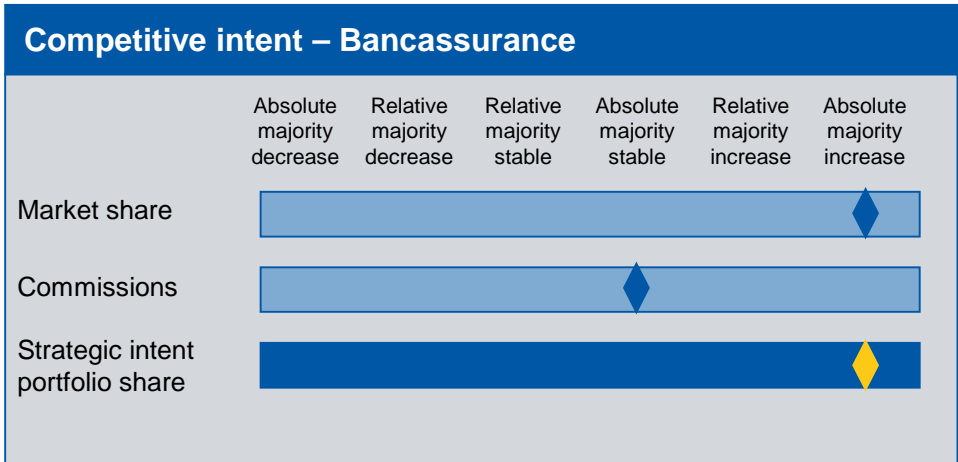


- CEOs believe that:
  - Direct insurance has a future in Russia as a channel but not as a stand alone brand
  - Channel conflict ins manageable
  - Technology is mostly ready
- ▶
- But CEOs also believe that
  - Legislation stands in the way of realising full cost benefits
  - Consumers are looking for information but not yet buying
  - Marketing cost is prohibitively high

■ Agree   ■ Disagree

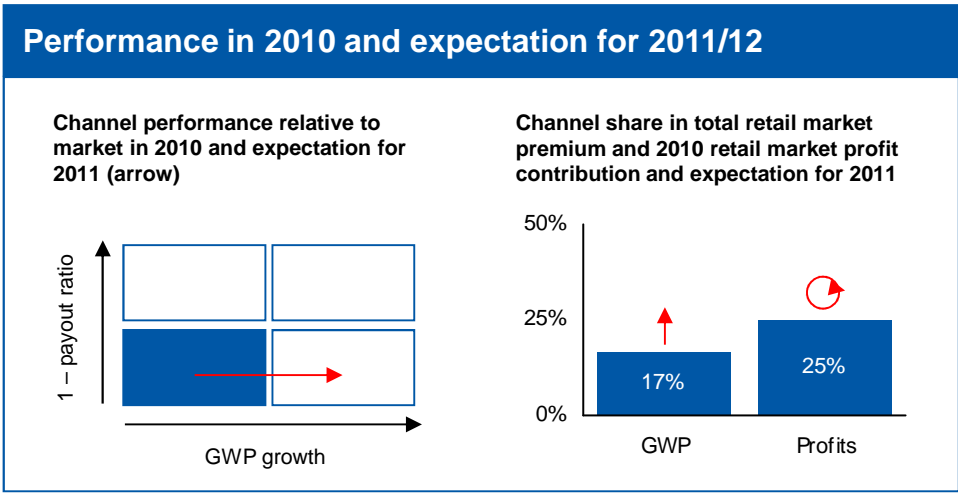
Source: Russian Insurance CEO Survey 2011; Oliver Wyman analysis

# Bancassurance channel competitive dynamics in 2011



### Interpretation and implications

- With economic growth the consumer and commercial credit markets have recovered quickly and premium for “consumption enabling” insurance products such as mortgage insurance, CASCO for new cars bought on credit are increasing quickly
- In addition, large banks have discovered the benefits of insurance as a source of risk free income and are now proactively expanding their insurance franchise (e.g. Sberbank)
- Given the already relatively large share of the bank channel for a predominantly P&C insurance market, competition for bank partnerships is high and commissions are therefore not expected to decrease
- Life and savings products, once they take off, would further boost the share of the bank channel in total insurance volume
- Insurers need to secure partnerships today and invest in operations and services if they are to secure strong positions in this growth channel



Source: Russian Insurance CEO Surveys 2011, 2010; Oliver Wyman analysis  
 1: Detailed results for all lines of business split by commercial and retail are available

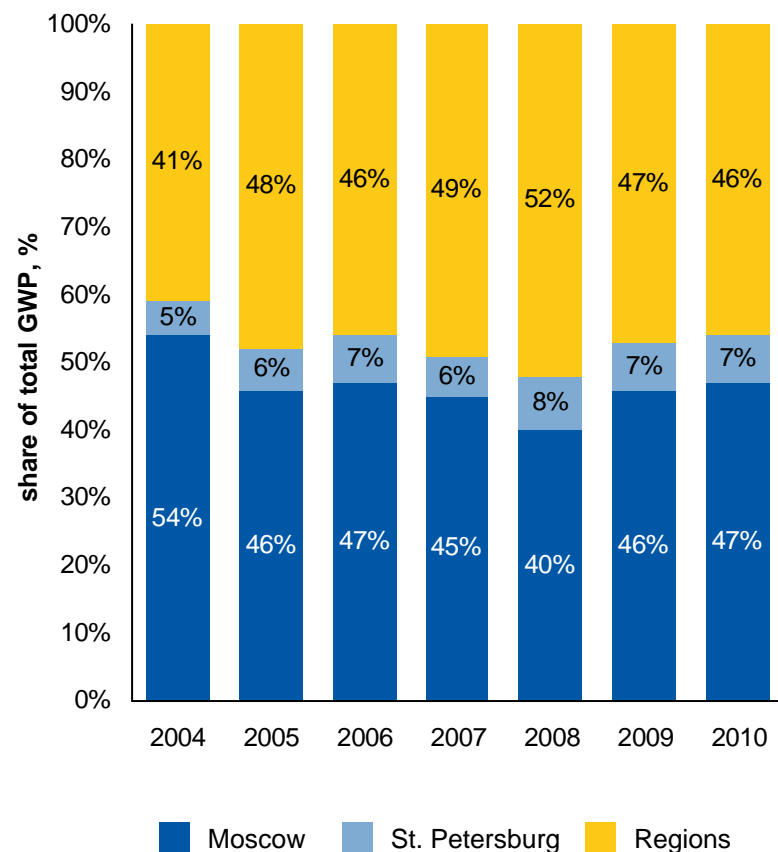
Section 3

# **CEO Outlook for 2011**

## 3.5 Regional dynamics

## The City of Moscow has historically dominated the Russian insurance market, accounting for roughly half of market premiums in 2010

**Historical GWP breakdown – urban centres vs. rest**  
FY 2010



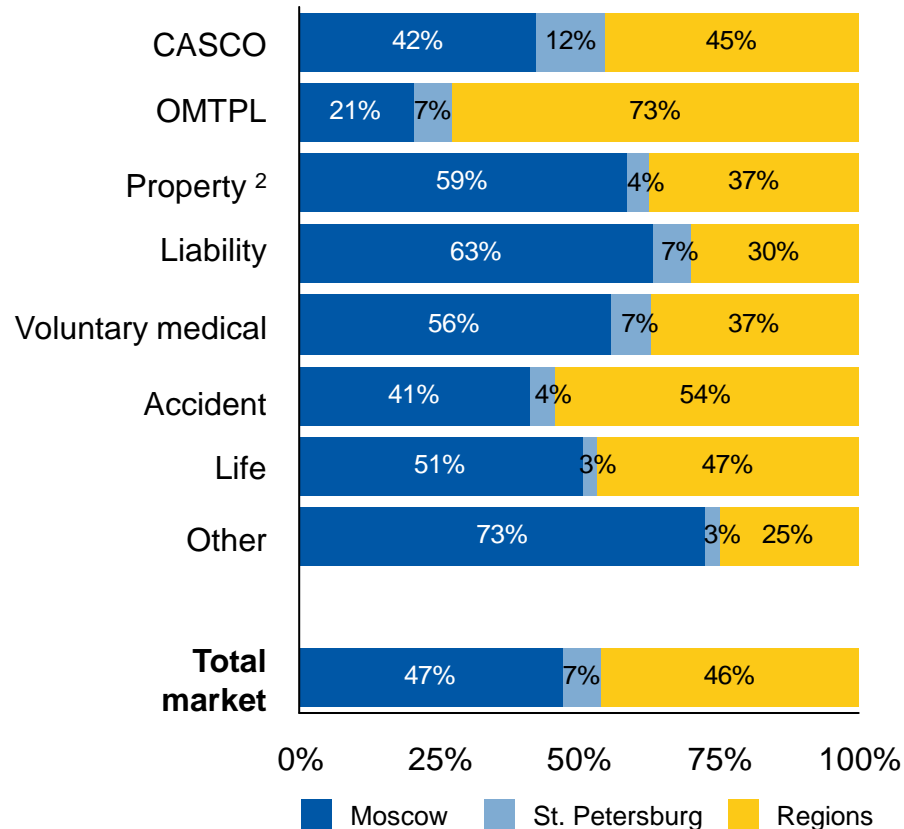
Source: Official insurance regulator figures; Oliver Wyman analysis.

### Comments

- The Moscow market dominates Russian insurance:
  - 47% of total premiums (excluding obligatory medical) were originated in Moscow in 2010
  - As the economic centre of Russia, Moscow was hit hard by the crisis in Retail as particularly CASCO sales fell dramatically
  - The OMTPL market which is almost 75% regional, was less affected and boosted the regional relative market share
- Moscow is undoubtedly a concentration point of Russia's wealth and financial services:
  - Corporate headquarters tend to be in Moscow, driving attribution of commercial premiums to Moscow market
  - The Moscow retail market is saturated with insurance companies and distribution intermediaries, contributing to a comparably higher degree of competition than in the regions

## Moscow and St Petersburg have a high share in commercial lines and above 50% market share in almost all other business lines except OMTPL

**GWP breakdown<sup>1</sup>: Urban centres vs. regions**  
FY 2010



Source: Official insurance regulator figures; Oliver Wyman analysis.

1. Figures may not sum exactly due to rounding error

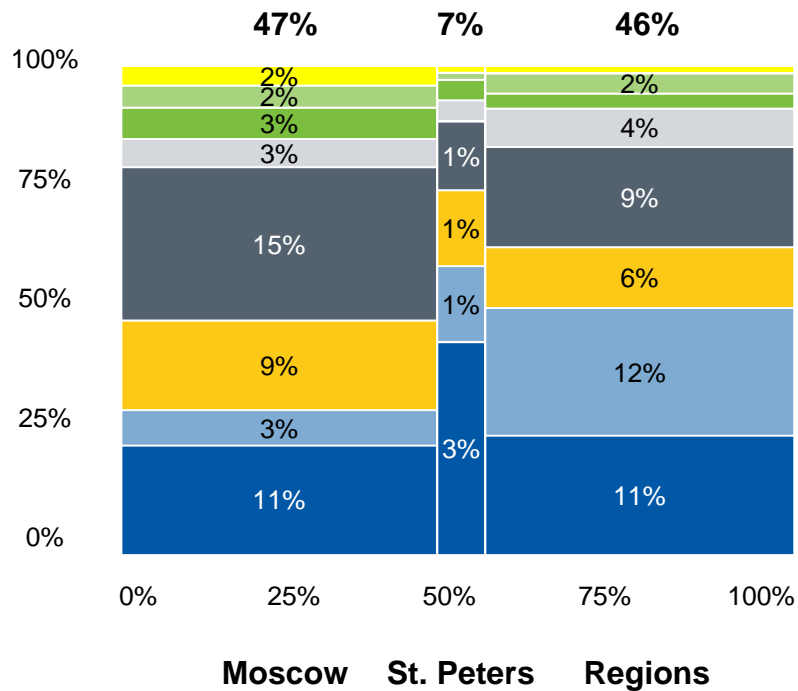
2. Total property, excluding CASCO.

### Comments

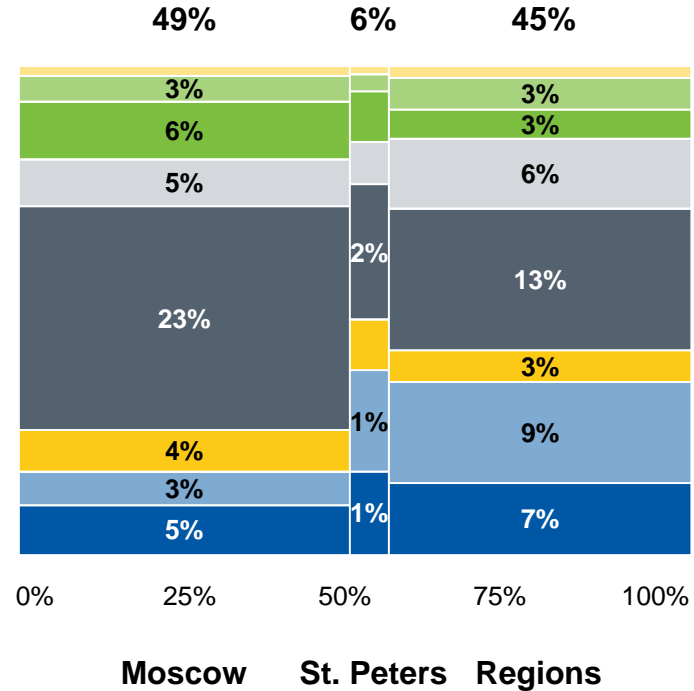
- 73% of OMTPL policies are written in the regions (reflecting larger share of cars in the regions versus the urban centres)
- 54% of CASCO policies are written in the two largest urban centres, more than in all the rest of the regions combined, reflecting the larger share of new, more expensive (foreign) cars in Moscow and St. Petersburg
- The urban centres have about 65-70% share in the commercial dominated business lines (property, liability and voluntary medical and other), reflecting the fact that Moscow and St. Petersburg have a high density of large company headquarters
- OMTPL and Personal Accident are the only business line where sales are significantly higher in the regions than in Moscow

## Moscow has been slightly more profitable than the regions, accounting for 49% of margin after claims payouts

**Market Gross Written Premium**  
(Premium pools), FY 2010



**Market profitability (1-payout ratio)<sup>1</sup>**  
("Profit" pools), FY 2010



■ CASCO  
 ■ OMTPL  
 ■ Property <sup>2</sup>  
 ■ Liability  
 ■ Voluntary medical  
 ■ Personal accident  
 ■ Other

Source: Official insurance regulator figures; Oliver Wyman analysis.

1. "Profit pools" proxy as: GWP less claims payouts. Does not include commission cost, operating expenses and investment income

2. Total property; excludes CASCO

Section 3

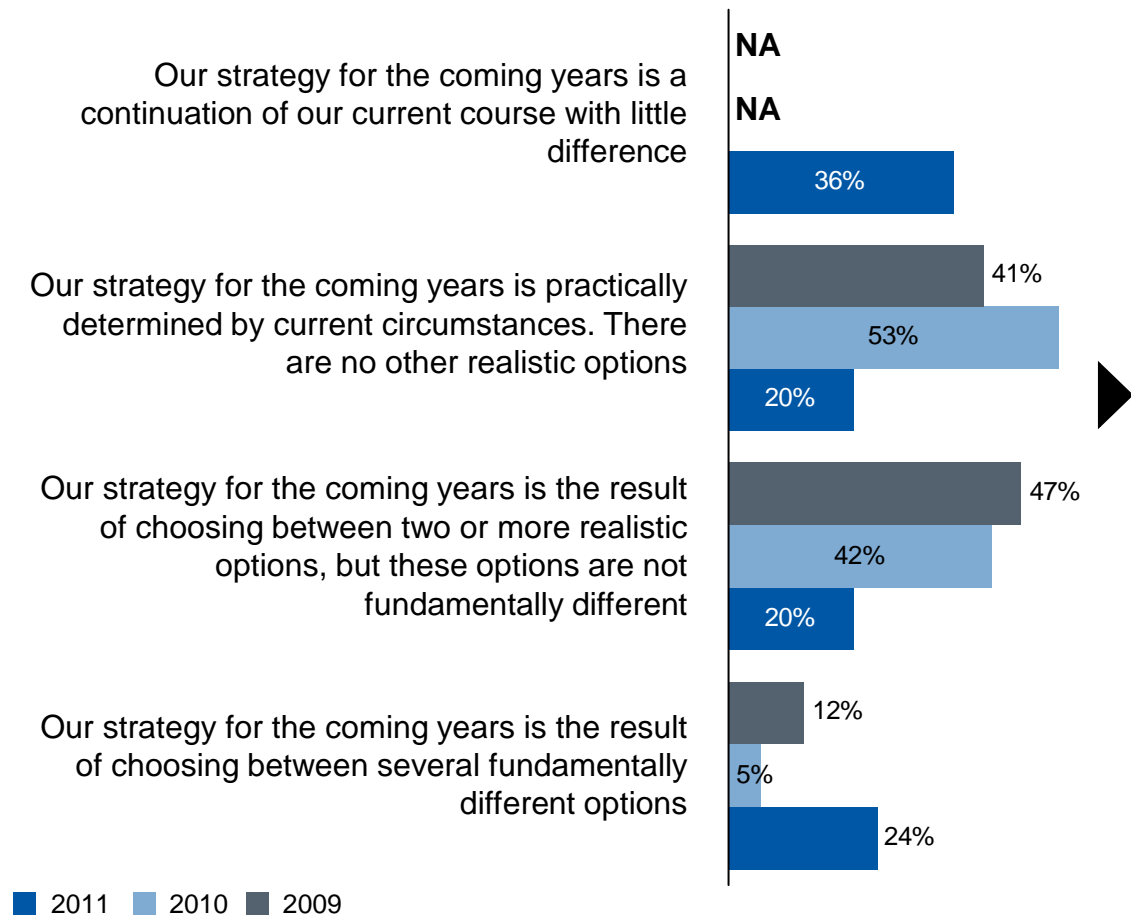
## **CEO Outlook for 2011**

### **3.6 Competitive intent and activity**

# CEOs see considerably more strategic choice than at the beginning of 2010 but a surprising number continue along the path set in the downturn

## Degree of freedom in setting strategy for 2011

Survey participants' perspective on own company



## Interpretation and trends

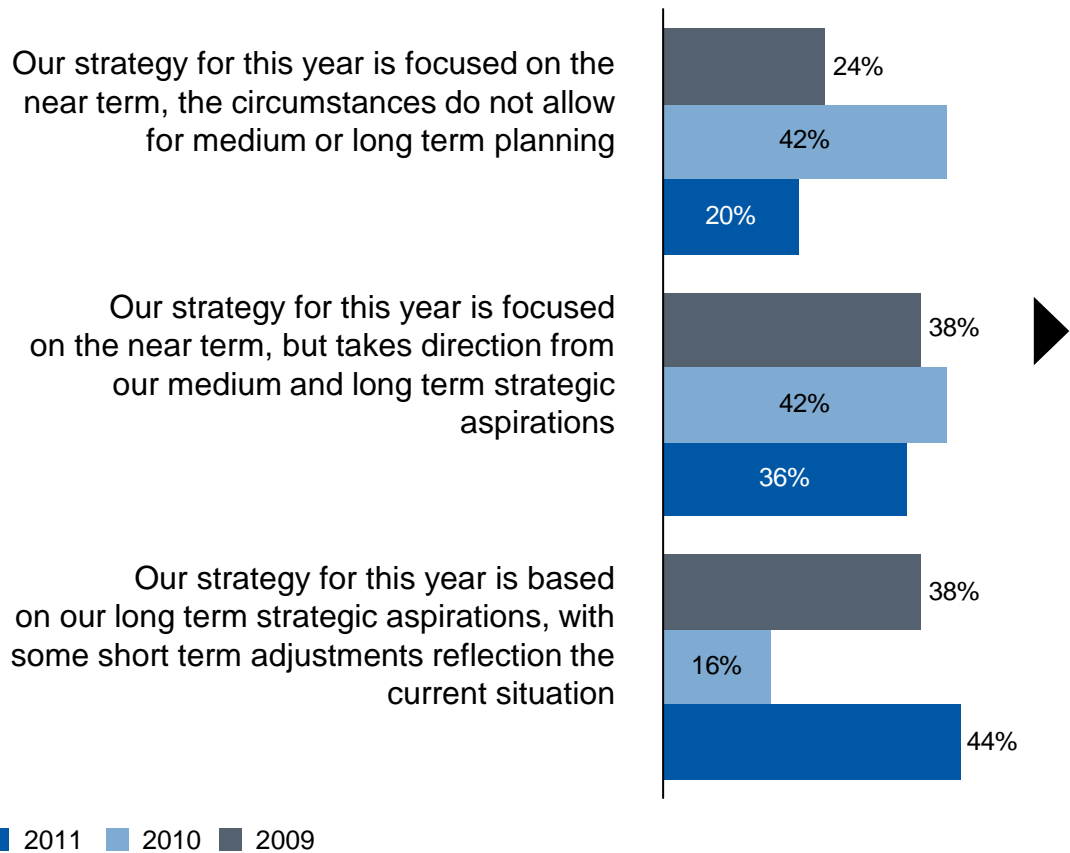
- At the beginning of 2010 an overwhelming 53 percent of CEOs had their strategy determined by current circumstances
- At the start of 2011, only 20% of CEOs found themselves without strategic choice
- About a quarter say, they are making fundamental choices on strategy this year
- Surprisingly more than a third seem to be continuing the path set out in the crisis
- This may partly be explained by the serious impact of the new capital requirements on smaller insurers who need to grow quickly to justify capital injections

Source: Russian Insurance CEO Surveys 2009 / 2010 / 2011; Oliver Wyman analysis

# Planning horizons have widened from focus on short term management to strategic longer term horizon slightly exceeding pre crisis levels

## Strategic planning horizon

Survey participant's perspective on own company



## Interpretation and trends

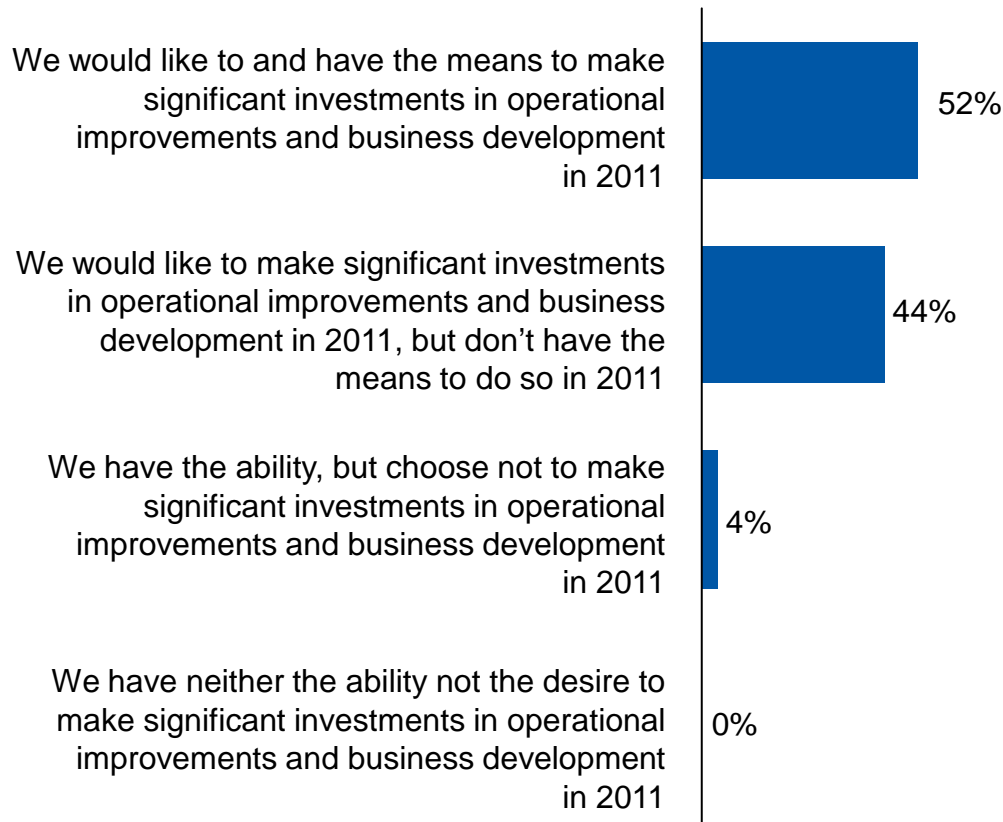
- Short term tactical action during the crisis (driven by liquidity pressure) has given way to longer term strategic planning
- However, about 20% of insurers remain in a crisis planning mode, in line with 20% of insurers who say that their strategic planning is determined by their current circumstances
- We suspect that these are smaller insurers who are significantly impacted by the new capital requirements for 2012

Source: Russian Insurance CEO Surveys 2009 / 2010 / 2011; Oliver Wyman analysis

# CEOs saw their companies suffer from structural illnesses during the crisis and are now seeking to address these issues by professionalizing their operations

## Strategic intent and ability

Survey participant's perspective on own company



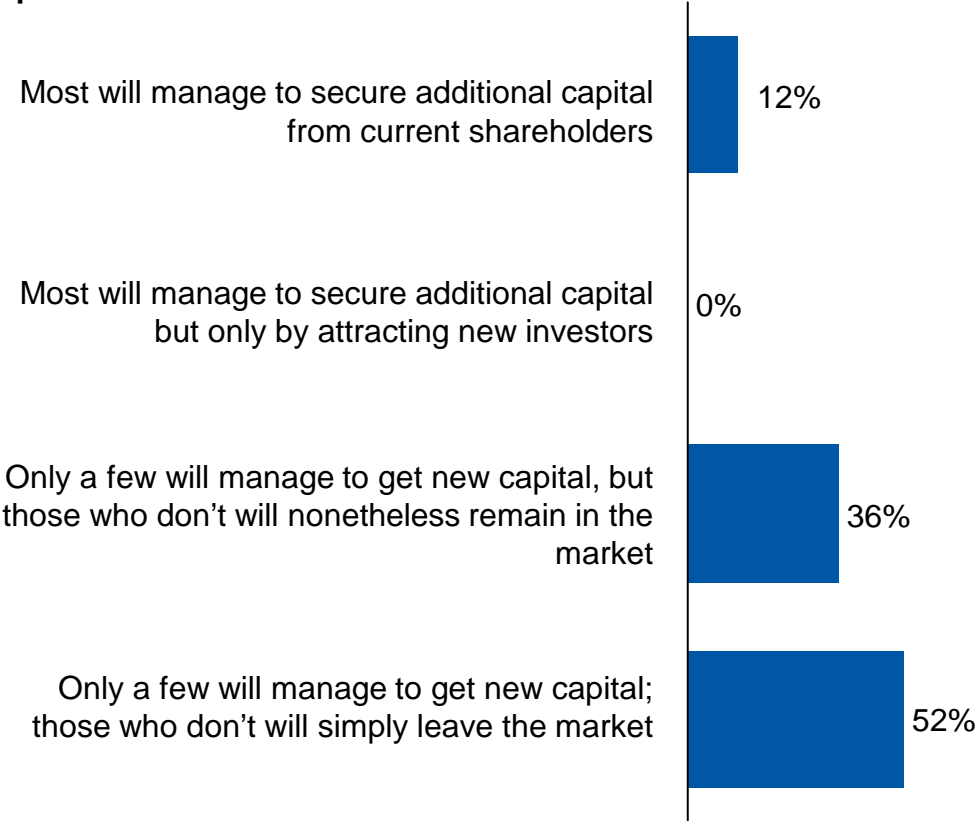
## Interpretation and trends

- More than 50% of survey respondents say that they now have the means and the resolve to make structural improvements in their companies
- However, more than 40% still cannot afford such steps given their weak financial situation
- Almost none chose to stay put if they have the resources and all have the desire for improvement of the operations

Source: Russian Insurance CEO Surveys 2009 / 2010 / 2011; Oliver Wyman analysis

## Survey participants believe that few of the undercapitalized insurers will receive fresh funding and expect that a large number will remain in business nonetheless

**What do you believe will happen in 2011 to those insurers who are currently undercapitalized versus the future capital requirements?**



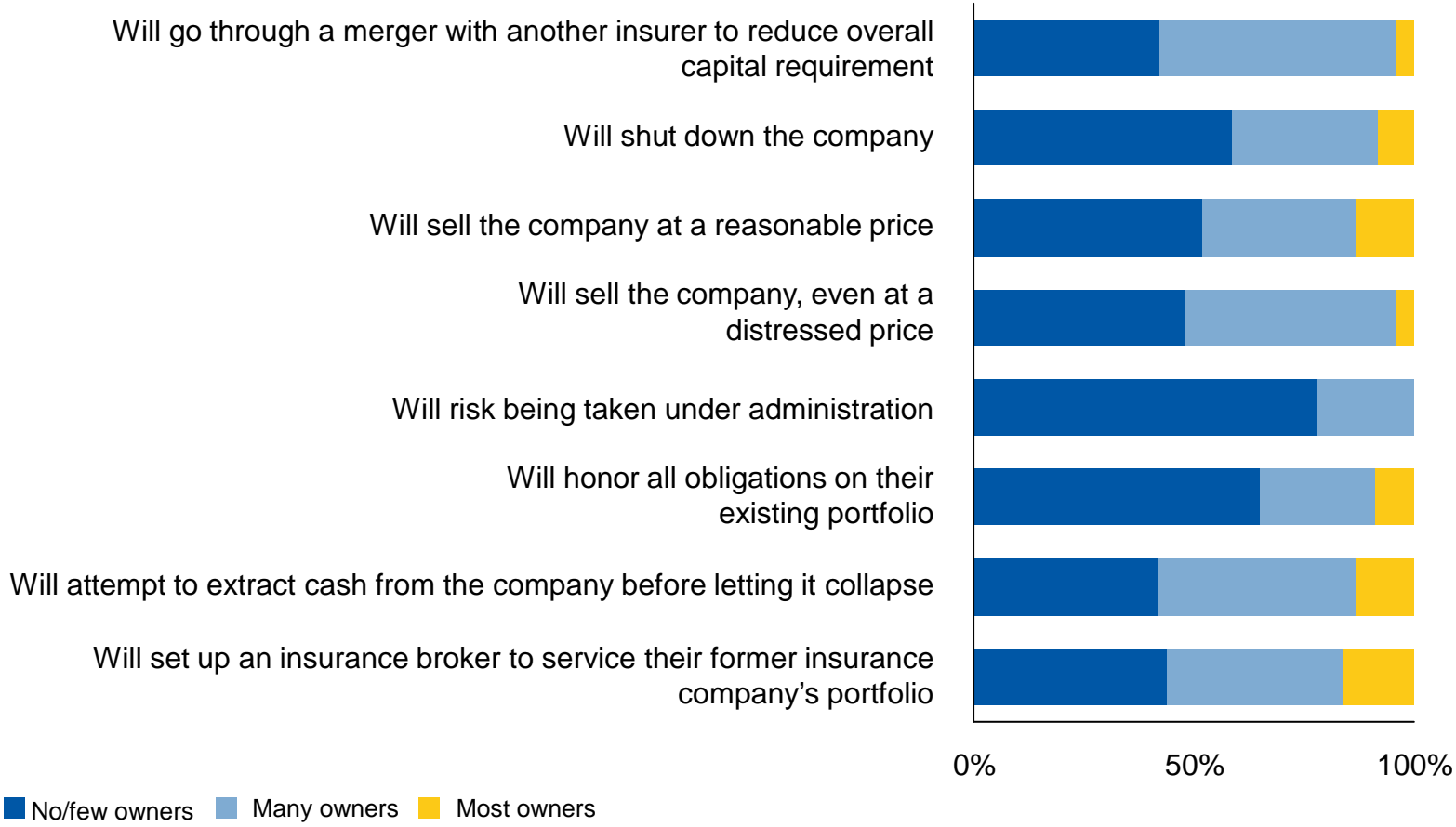
### Interpretation and trends

- Survey participants do not expect that undercapitalized insurers will receive additional capital from their shareholders to cover the gap to meeting the new 2012 capital requirements
- More than 50% believe that those often small insurers will exit the market
- However, more than one third expect that many of these companies will remain active underwriters despite being in violation of regulatory requirements

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## CEOs fear that many of the capital weak insurers will resort to unethical behaviors before going out of business

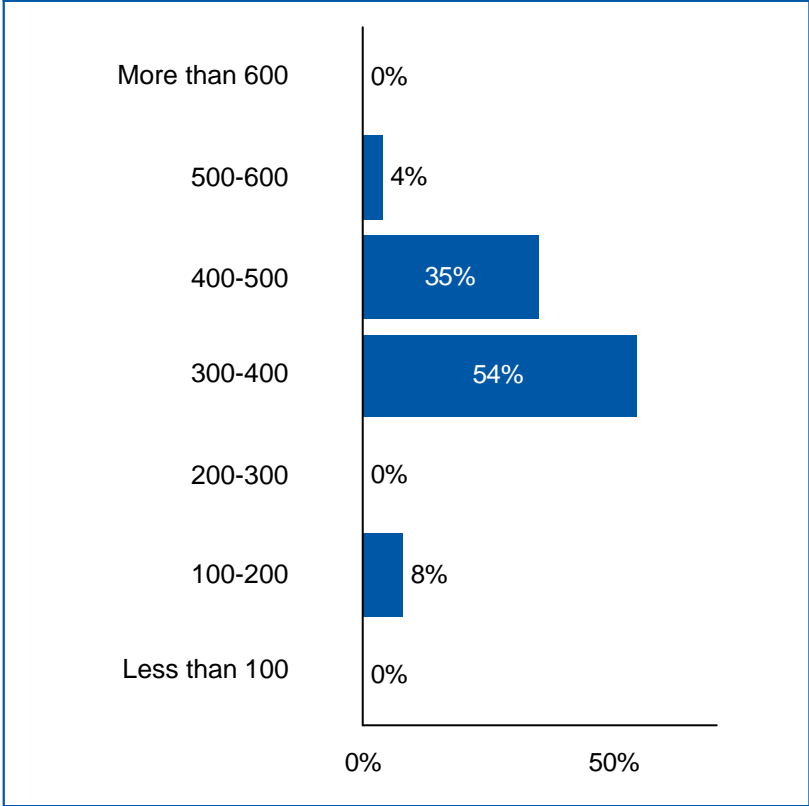
**What do you believe the owners of undercapitalized insurers who are unable to raise the necessary additional capital will likely do in 2011?**



Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

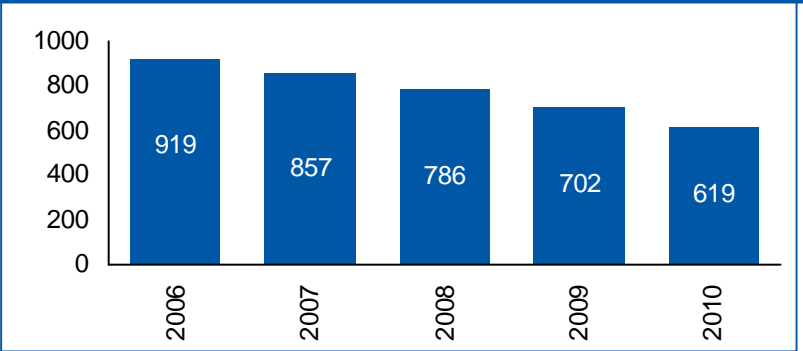
## Nonetheless, CEOs expect that there will be a significant reduction of the number of insurance companies in the market by end of 2012

Today, there are approximately 650 insurance companies operating in the Russian market. How many do you believe will be active at the start of 2012?



Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

### # of insurers in the Russian insurance market

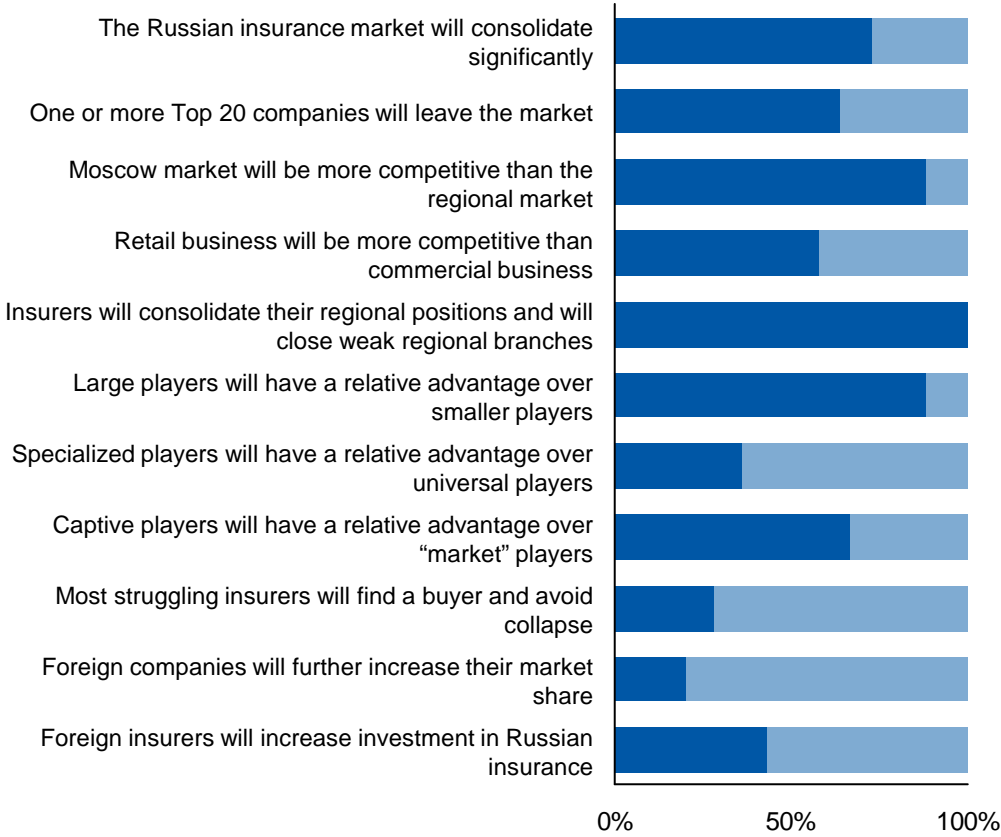


### Interpretation and trends

- More than half of the survey respondents expect that no more than 300 to 400 companies will be left by 2012, potentially less than 50% of the 619 at the end of 2010
- Still more than a third believes that there will be reduction to some 400-500 companies, taking up to 250 companies out of the market
- Leading companies see this as an opportunity to capture market share taking advantage of migrating customers and distribution assets

# Consolidation to the benefit of the large players is seen as a key development trend in the near to medium term

## What do you think will be true about the competitive landscape of the Russian insurance market in 2011?



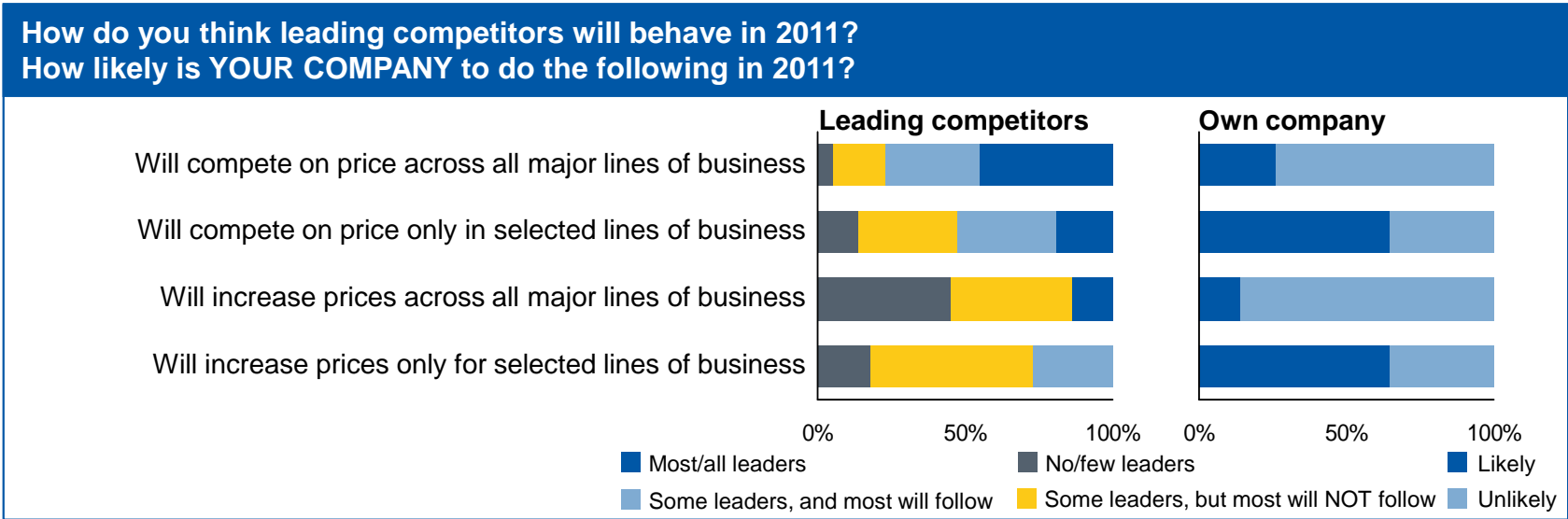
■ Agree ■ Disagree

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## Interpretation and trends

- The majority of Survey participants expect a significant consolidation of the market
- Weak players will not find buyers and the large players become clear winners in migration of customers and distribution assets
- Many survey participants would not be surprised if a top 20 player leaves the market
- Moscow and other urban centers are expected to be more competitive than the regions
- Insurers are expected to consolidate their regional positions and close unprofitable branches
- Foreign companies are expected to grow only with the market and to invest less euphorically than pre crisis

## 2/3 of CEOs want to pursue a differentiated pricing strategy but they expect that industry leaders will compete more indiscriminately on price



**Interpretation**

- Traditionally survey participants claim that they will pursue a differentiated pricing strategy, competing on price only in selected business lines and increasing prices in unprofitable business lines
- Traditionally survey participants expect that some market leaders will compete more indiscriminately on price and that most other market leaders will follow and that few market leaders will increase prices
- The resulting dynamic draws all insurers in destructive price competition as shareholders still demand to see strong growth even if this implies eroding margins

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## About 50% of CEOs show some readiness to exit unprofitable business lines, but they do not expect that market leaders will exit lines even if unprofitable

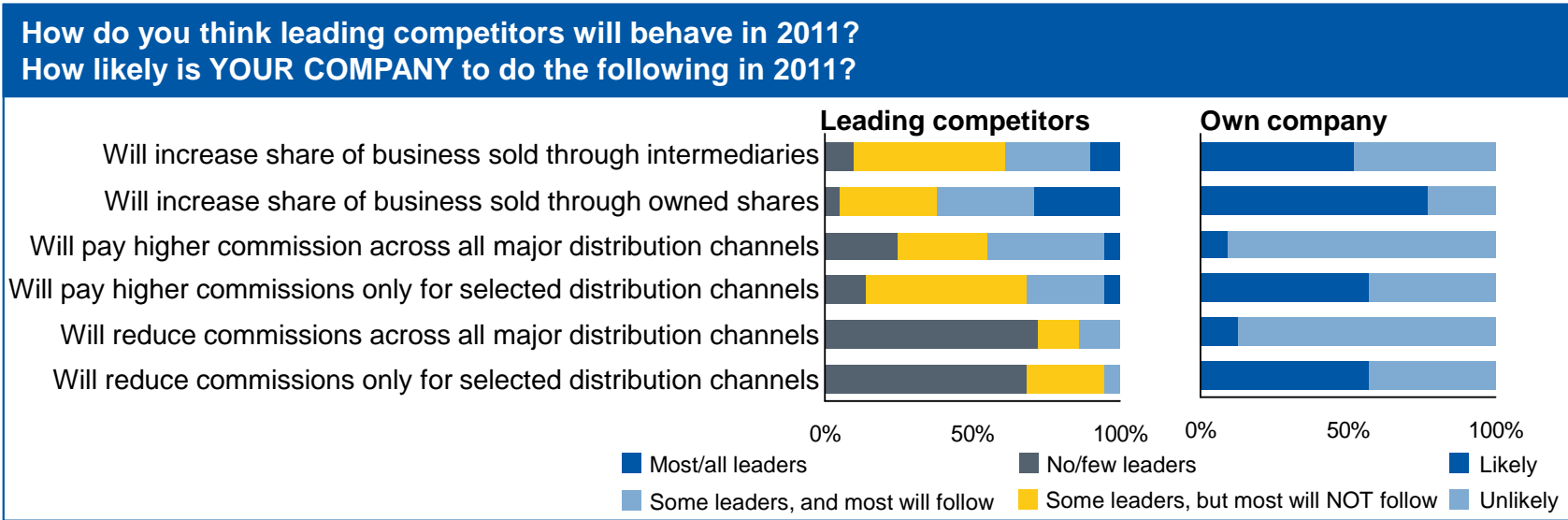


**Interpretation**

- Survey participants declared some readiness (above 50% of participants) to exit unprofitable lines of business
- However, their expectation is that market leaders will stay even in unprofitable lines to maintain their market share
- Survey participants also showed some readiness to rationalize their local footprint, exiting unprofitable regional markets and expanding into profitable geographies
- However, their expectations are that most market leaders will not follow such a strategy even if some market leaders exit unprofitable regions
- More than 50% expect to see an expansion of the regional networks of market leaders

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

**Almost 80% of CEOs want to increase the production of their owned channels, and about 60% want to pursue a differentiated commission strategy**

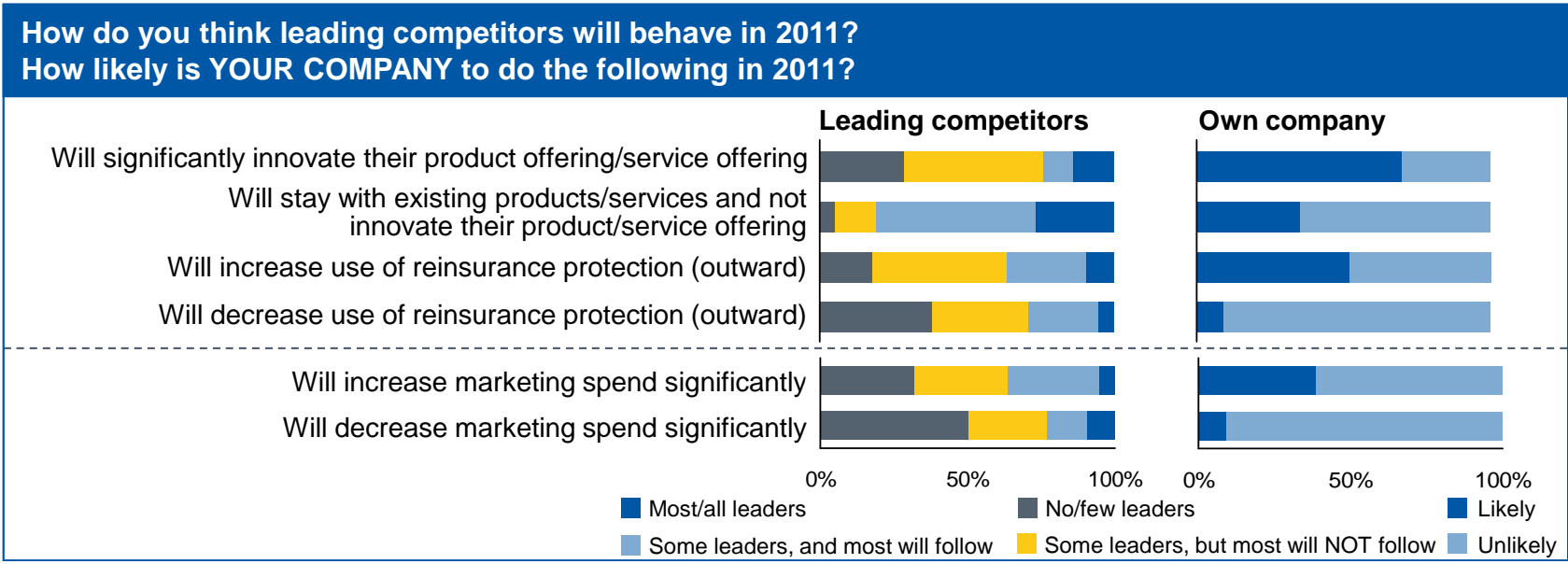


**Interpretation**

- About 80% of CEOs want to increase the share of their premium coming from owned channels
- About 60% of CEOs want to increase the share of business sold through intermediaries
- Very few want to compete on commission in all channels
- More than 60% seek to implement a differentiated commission strategy
  
- CEOs expect market leaders to grow the share of business coming from owned channels
- However, they believe that market leaders will maintain commissions at current levels, seeking neither reduction or increase of market share bought through raising commissions

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

**There is a clear trend to expand the share of owned channels in premium production and a strong opinion that marketing expense will stay at 2010 levels**

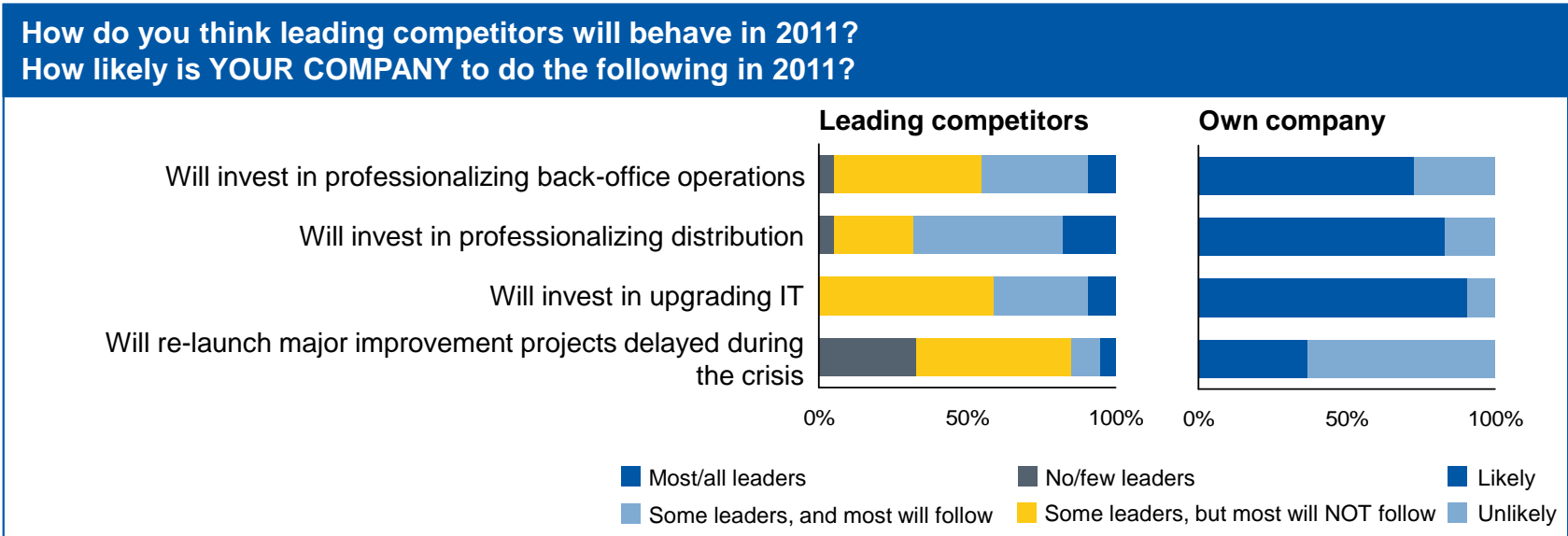


**Interpretation**

- About 75% of CEO plan to innovate their product and service offering, and only 40% want to stay with their existing offering
- About 60% of CEOs want to increase the use of reinsurance and only very few want to retain more risk on their books
- However, they expect market leaders to do little in terms of product and service innovation and also do not expect a change their use of reinsurance
- Only 40% of CEOs want to increase their marketing spend significantly; most want to continue at the current expense level
- The same marketing investment behavior is expected from market leaders

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

# CEOs want to professionalize distribution, the back office and invest in IT and expect market leaders to emphasize improvements in distribution

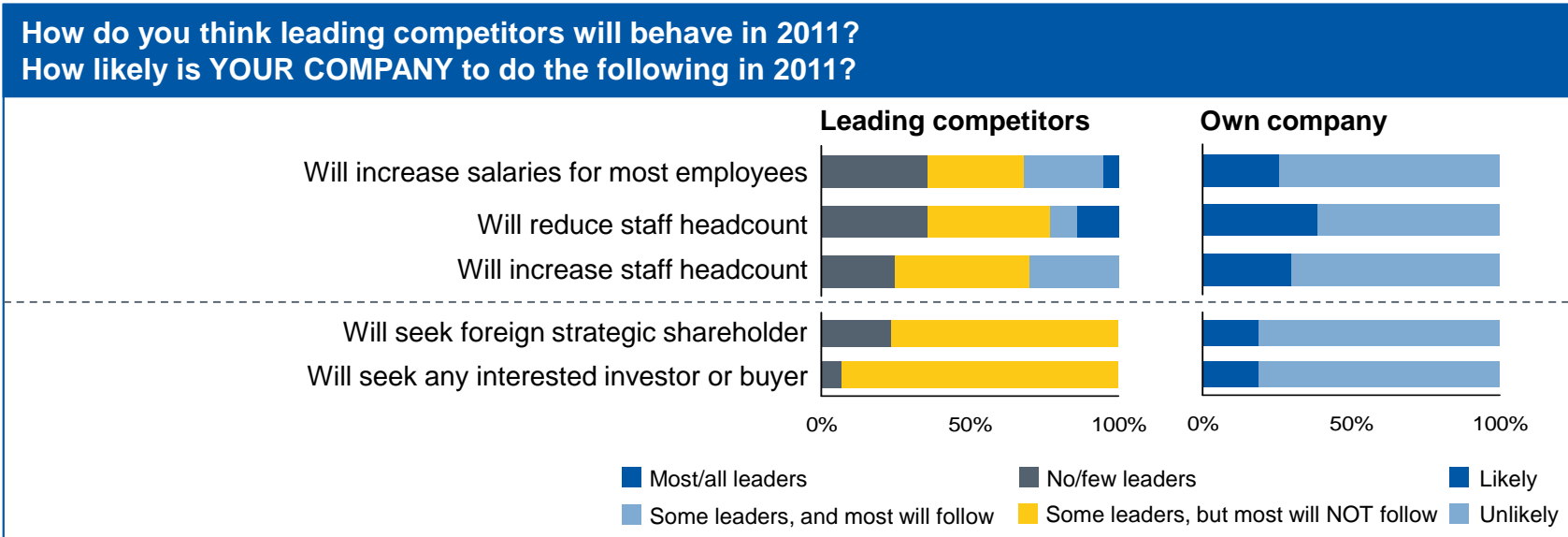


**Interpretation**

- Most CEOs want to professionalize their back-office operations, their distribution and invest in IT
- However, only 40% say that they will re-launch major improvement projects delayed during the crisis
- Market leaders are expected to emphasize professionalizing their distribution with professionalizing the back-office and upgrading IT coming as clear second priorities
- Market leaders are not expected to re-launch pre crisis initiatives

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

## Insurers want to contain staff cost by containing salaries and not hiring additional staff – The interest and expectation in M&A activities is low



**Interpretation**

- CEOs do not plan to increase employee salaries and staff headcount and expect that most market leaders will do the same
- CEOs do not expect that market leaders will seek foreign strategic investors or other investors or buyers for their company
- Only about 20% of CEOs seek investors or buyers for their own company

Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

Section 3

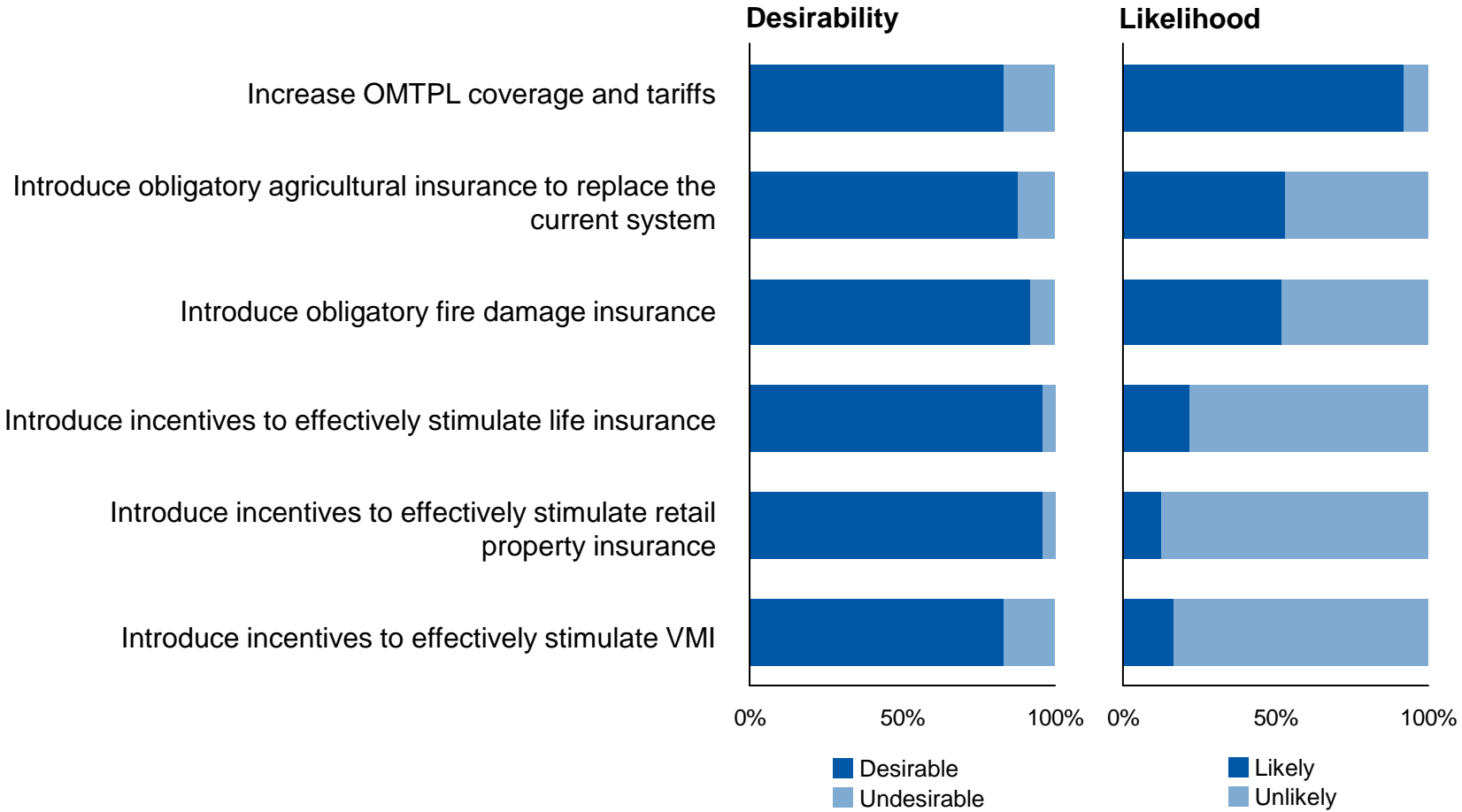
## **CEO Outlook for 2011**

### **3.7 Regulation and legislation**



# Almost all insurers favour the introduction of further obligatory types of insurance

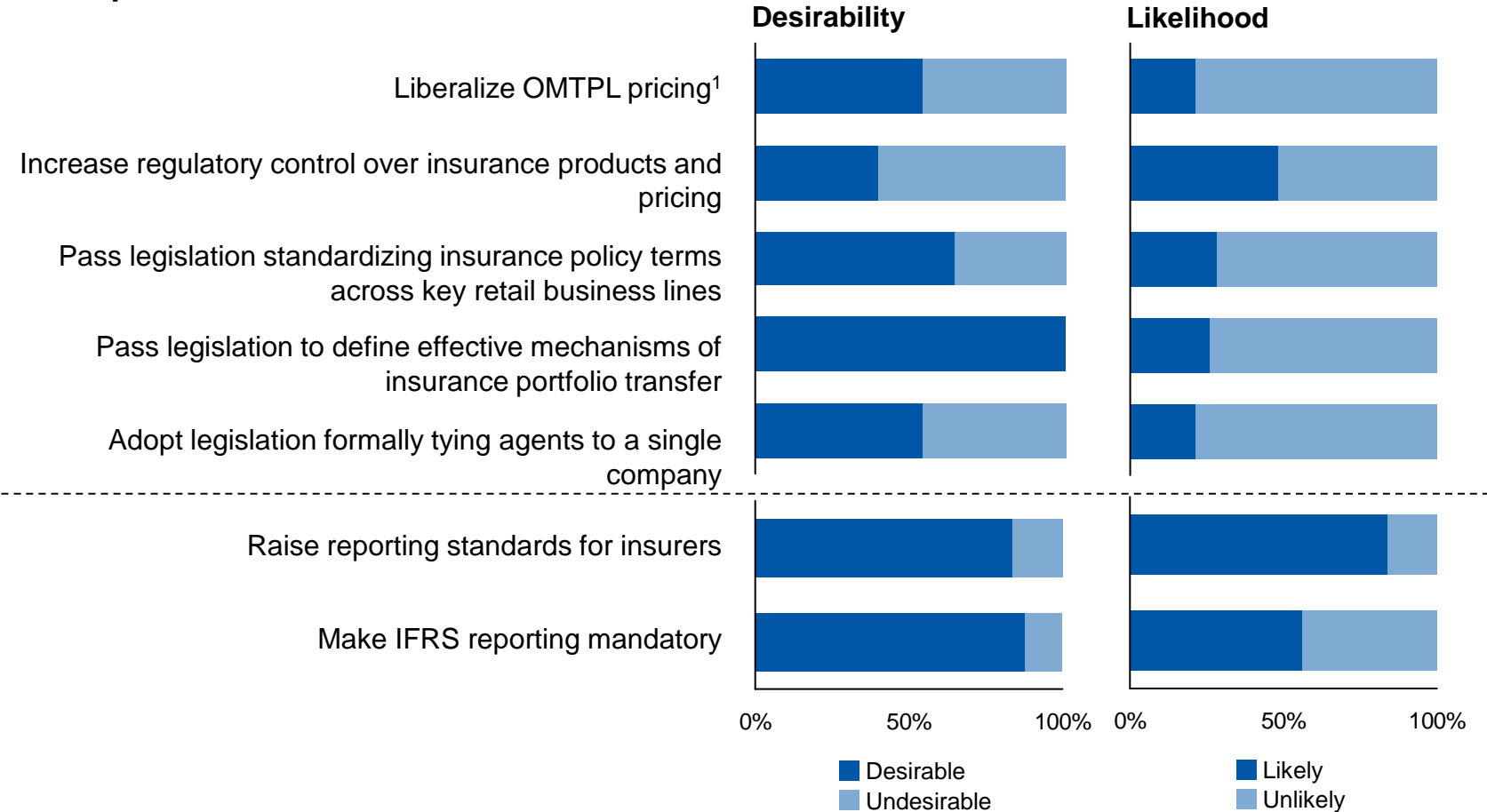
What are your views as to the likelihood and desirability of the following regulatory / legislative developments?



Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

**The opinion on the desirability of market liberalisation is divided but CEOs expect and welcome the introduction of IFRS and tougher reporting standards**

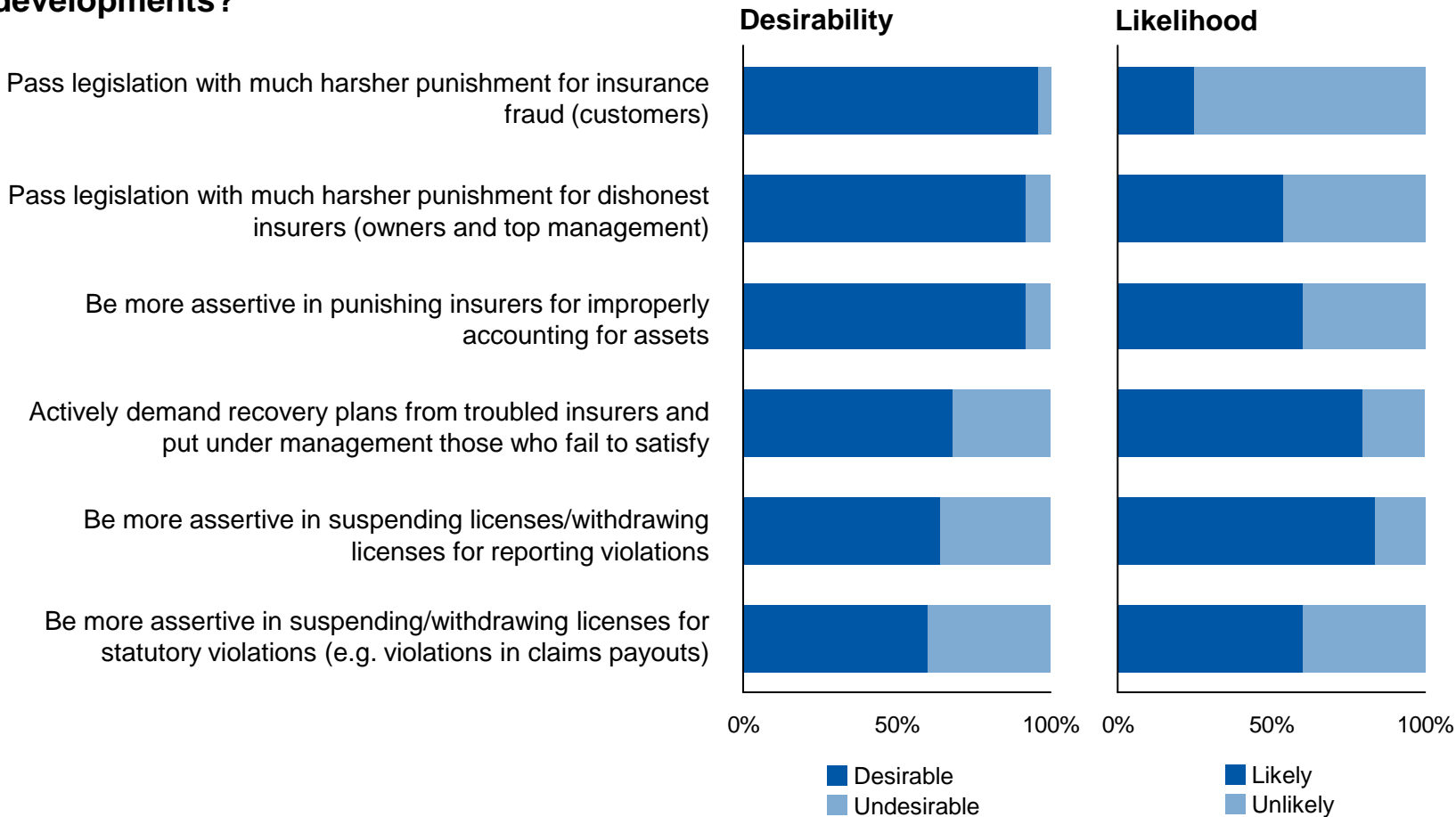
**What are your views as to the likelihood and desirability of the following regulatory/legislative developments?**



Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis  
 1: Poll was taken before OMTPL liberalisation became an actively considered topic

# Insurers favor tougher action on fraud and tougher action on unprofessional and non-compliant insurance companies and believe that action in this direction will be taken

**What are your views as to the likelihood and desirability of the following regulatory/legislative developments?**



Source: Russian Insurance CEO Survey 2011, Oliver Wyman analysis

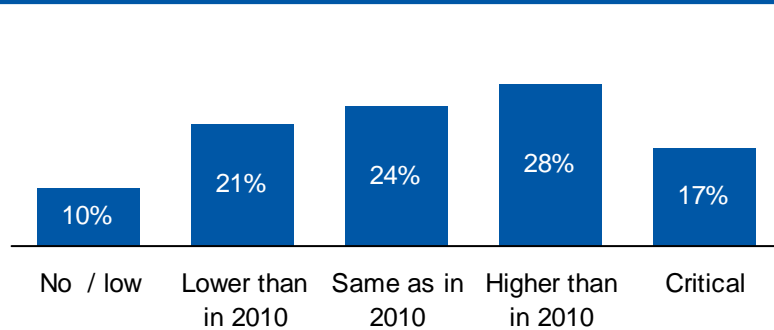
Section 3

# **CEO Outlook for 2011**

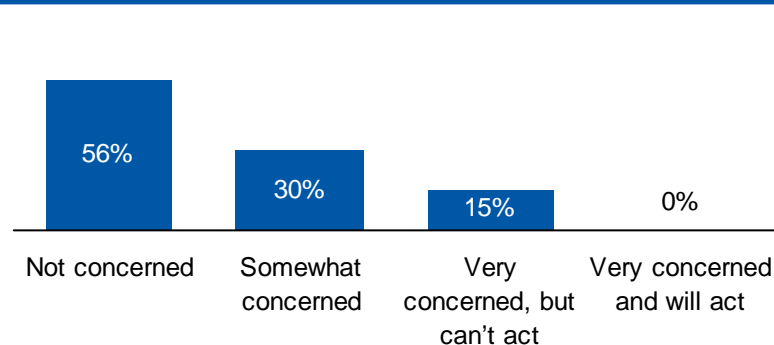
## 3.8 M&A and valuation

## Acquisition are not yet a topic for most insurance CEOs

### Pressure on insurers' ability to finance M&A Survey participants' perspective on market



### Concern over own ability to finance M&A Survey participants' perspective on own company



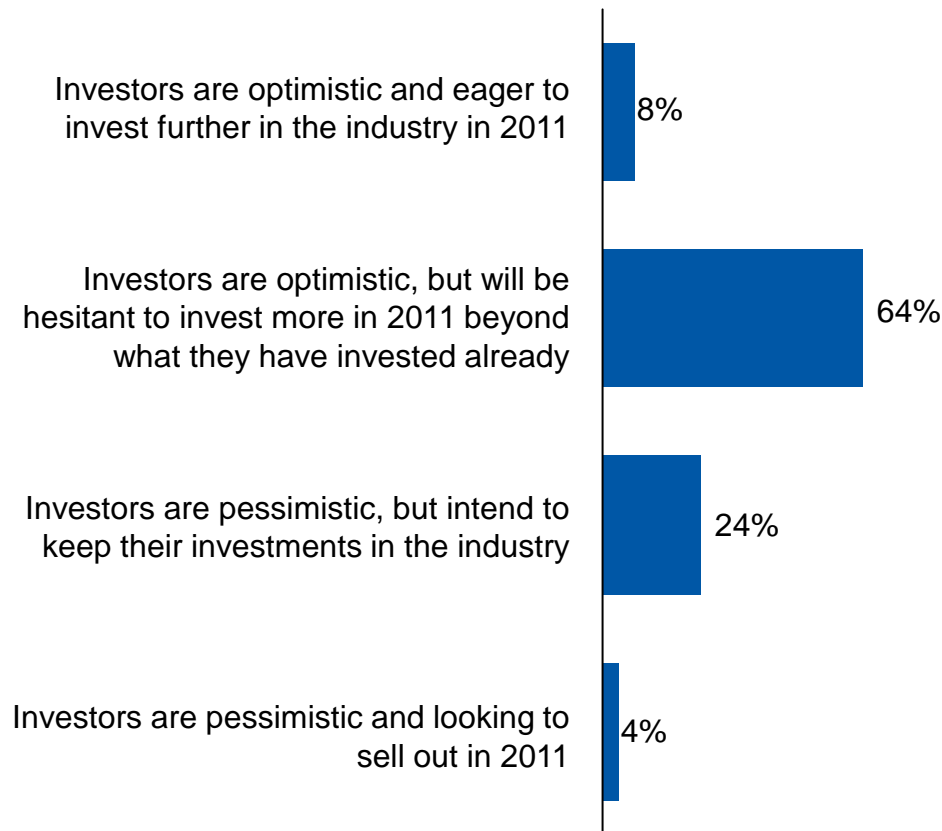
### Interpretation and trends

- Russian insurance CEOs feel in a better position to react to acquisition opportunities than in 2010
  - Regained confidence in market growth
  - Opportunity to acquire portfolio and distribution assets of smaller / struggling insurers at attractive prices
- However, strategic M&A seems not to be on the screen for most insurers
  - Interest in significant acquisition comes mostly from foreign insurers who have missed out in the first wave of acquisitions or seek to solidify / strengthen their market position
  - Shareholders of industry groups seem to be willing to make bets on regulatory development, for example in the Obligatory Medical Insurance sector
- Consolidation will partly be driven by consolidation of legal entities within insurance groups to reduce capital requirements and administrative burden

Source: Russian Insurance CEO Surveys 2011, Oliver Wyman analysis

## Survey participants have a realistic view on investor sentiment towards the Russian insurance market

**What impact do you believe the experience of 2009-2010 has had on the attitude of investors in Russian insurance?**



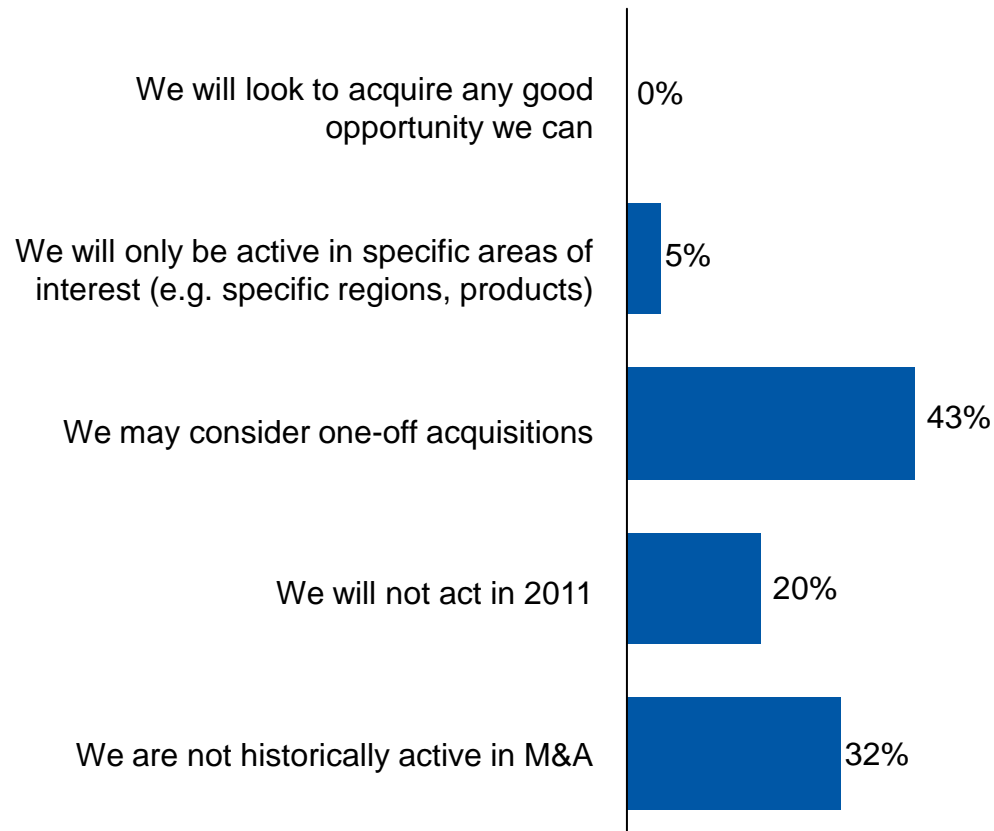
### Interpretation and trends

- Today, investors are significantly more cautious about investment in Russia in general and in Russia's insurance sector in particular
- Many strategic investors in insurance favor other BRIC markets over Russia
- PE investors are cautious and find other sectors more attractive
- The crisis has not uncovered new fact, but has resulted in a shift in interpretation
- Market development inertia, slow regulatory development and prevalence of cash-flow underwriting and a high degree of inefficiency are now seen more as issues than as opportunities

Source: Russian Insurance CEO Surveys 2011, Oliver Wyman analysis

## Growth through strategic acquisition is not on the mind of survey participants, even though more than 40% say they would consider one-off acquisitions

### To what extent are you going to be active in acquisitions in 2011?



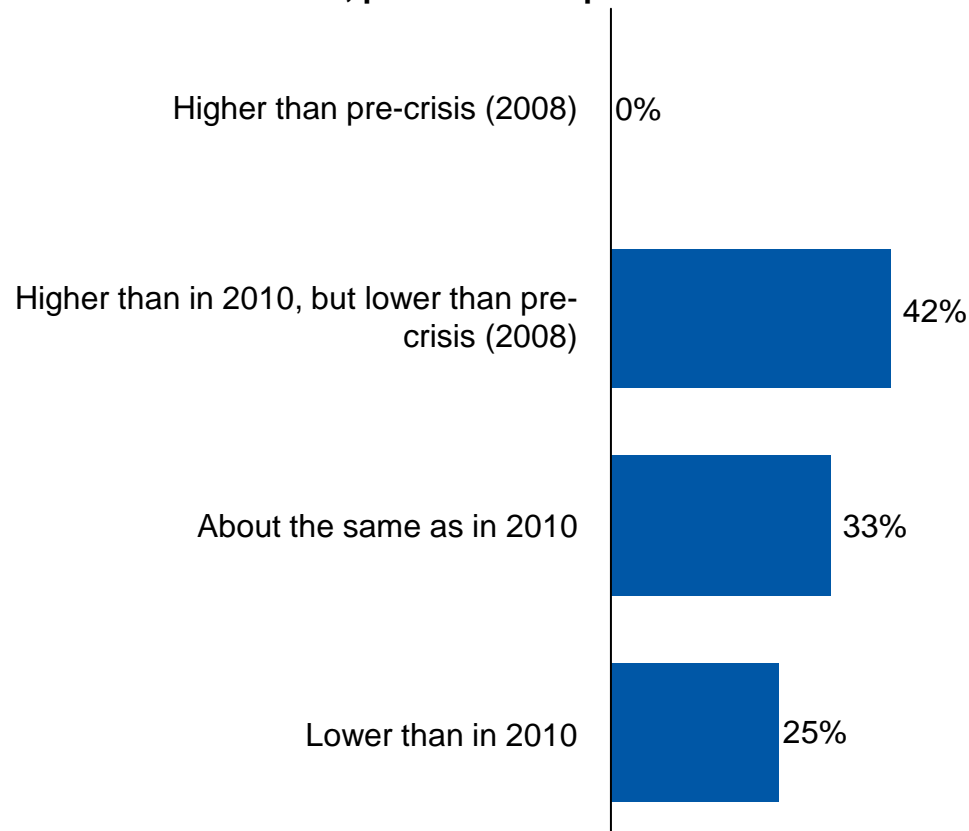
### Interpretation and trends

- Survey participants are not looking to grow through acquisition
- However, more than 40% would consider one-off acquisition if a good opportunity comes along
- Given that few insurers have the capital to do major acquisitions on their own, and given that shareholders (domestic and foreign) have other opportunities for investment, major acquisitions by incumbents seem unlikely in 2011/12
- However, this does not include new market entry and or acquisition by banks who may take advantage of low asset prices and start to prepare for participating in a fledgling Pensions and Savings market

Source: Russian Insurance CEO Surveys 2011, Oliver Wyman analysis

## Survey participants are still cautious about recovery of insurance company valuations in 2011

To what extent do you think the valuation of Russian insurance companies has changed since the onset of the crisis in autumn 2008? Overall, premium multiples in 2011 will be...



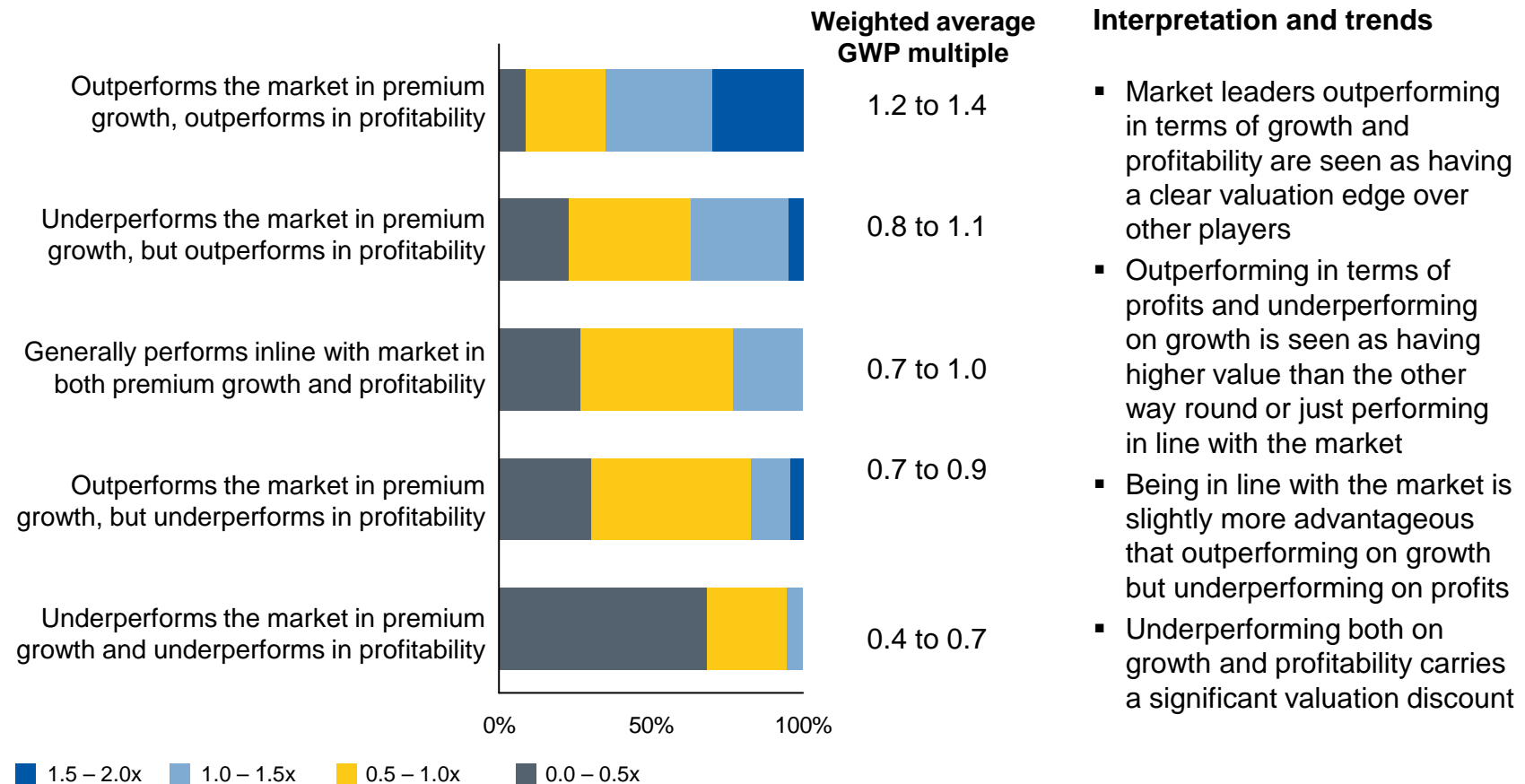
### Interpretation and trends

- The crisis highlighted major weaknesses of the Russian insurance market and its companies including:
  - Market growth depending cash flow operating model
  - Inefficient operations
  - Hostage to distribution partners
  - Low product / channel innovation
  - Growing but low margin market
- High premium multiples have been reversed coming down to one times premium only for well performing insurers
- Insurance CEOs understand the shift in valuation but not all shareholder have made that step yet

Source: Russian Insurance CEO Surveys 2011, Oliver Wyman analysis

## Valuation estimates range between 1.2 and 1.4 times GWP for outperforming companies, and profitability is seen as more valuable than growth

**What premium multiples do you believe can be achieved for typical insurance companies that can be characterized as having the following performance versus market?**



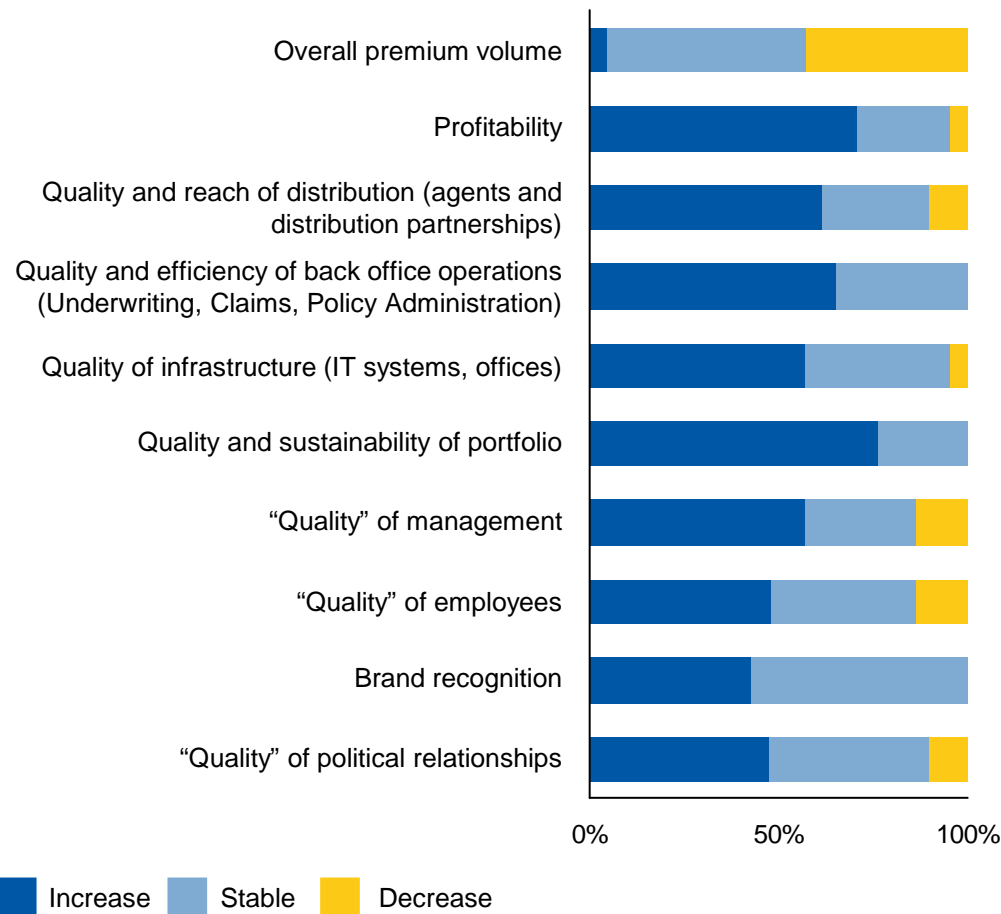
Source: Russian Insurance CEO Surveys 2011, Oliver Wyman analysis

### Interpretation and trends

- Market leaders outperforming in terms of growth and profitability are seen as having a clear valuation edge over other players
- Outperforming in terms of profits and underperforming on growth is seen as having higher value than the other way round or just performing in line with the market
- Being in line with the market is slightly more advantageous than outperforming on growth but underperforming on profits
- Underperforming both on growth and profitability carries a significant valuation discount

## CEOs agree that there is a significant shift in how companies will be valued with premium volume no longer being the only and dominant measure

### Change of relative importance of value drivers in 2009/2010



- Respondents agree that premium volume remains an important, but not dominant measure for valuation
- Profitability, quality and sustainability of portfolio and operational professionalism are increasingly recognised as important valuation criteria
- Quality of employees has come down in importance compared to last year's survey results
- Importance of brand and quality of political relationships has increased

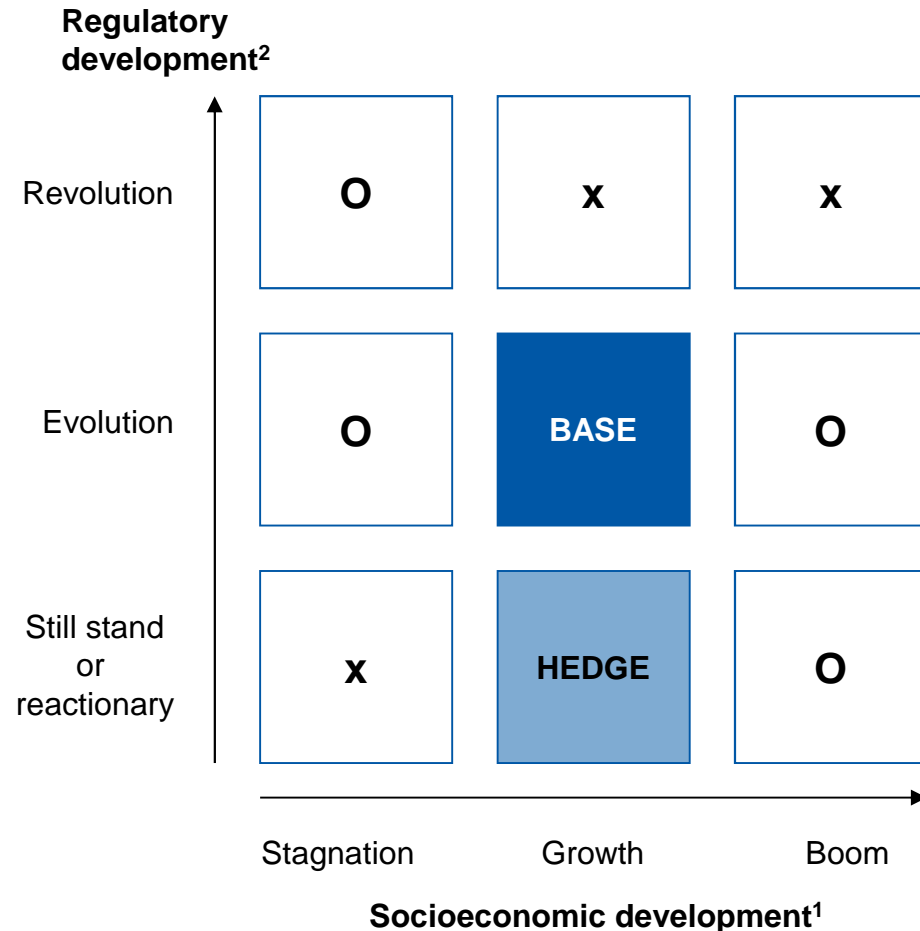
Source: Russian Insurance CEO Survey 2010; Oliver Wyman analysis

4

## **Synthesis and Oliver Wyman perspective**

### **4.1 Long term scenarios**

**We see two distinct market development scenarios, with regulatory development as the decisive driver, assuming healthy economic growth over the next years**



### Argumentation

- Most likely socioeconomic scenario is growth<sup>3</sup>, neither stagnation nor boom
- Most likely regulatory development are still stand and evolution, not revolution
- Base scenario is “growth with regulatory evolution”
- Hedge scenario is “growth with regulatory still stand”.
- Other scenarios are unlikely for either of two reasons
  - X** Combination is inconsistent
  - O** Combination is less likely

1. "Socioeconomic development" includes (1) Macroeconomic development, (2) Sociodemographic development, (3) Consumer sentiment and (4) Technological development

2. "Regulatory development" includes legislative development going beyond direct insurance industry regulation

3. Given the ongoing sovereign crisis in the EURO countries, a "return of the crisis" scenario should be a standard scenario of strategy discussions

## In the BASE SCENARIO, the cash flow model disappears, the industry consolidates and many of the current development hurdles are removed

### Scenario characterization

- Economy shows healthy growth, outgrowing the major mature economies, socioeconomic development prospers and investment into telecom, health and other key infrastructure increases notably
- Regulator/Legislator introduce qualitative improvements to financial industry regulation and regulation of insurance in particular, removing some of the hurdles which stay in the way of structural development e.g.,
  - Nationwide motor claims database, removal of BCO requirements
  - Ease of data protection law, ease of constraints on bancassurance

### Impact on market structure and dynamics

- Cash flow operating model phases out and market consolidation accelerates
  - Some 300 insurers by 2013
  - Some 200 insurers by 2016
- Market achieves significant growth (20% and more) in line with economy and additional unlocked growth potential. Margins recover because of reduced number of more professional competitors and tighter capital requirements
- 2016 foreign share in insurance market significantly higher than today

### Impact on investor sentiment

- Interest for investment in Russian insurance market revives as market becomes structurally more attractive. This assumes that:
  - Foreign insurers will be on the growth quest again and willing to take risks
  - Reform in Russia's financial sector eases negative view on Russia
  - Financial investors are willing to take a bet, IPOs have a chance of success
  - Valuations recover but high pre-crisis multiples will not return

## In the HEDGE SCENARIO, development will be slower, structural development inertia will remain, counter intuitively even in an economic boom

### Scenario characterization

- Economy shows growth and socioeconomic progress and infrastructure investment are similar to the base scenario or even better (economic boom)
- Regulator and legislator do little to structurally improve the regulatory framework for insurance and the financial services sector in general
- Changes to insurance regulation are predominantly “reactionary” for example introducing new mandated insurance with questionable socioeconomic benefit, or increasing tariffs and coverage on mandated lines

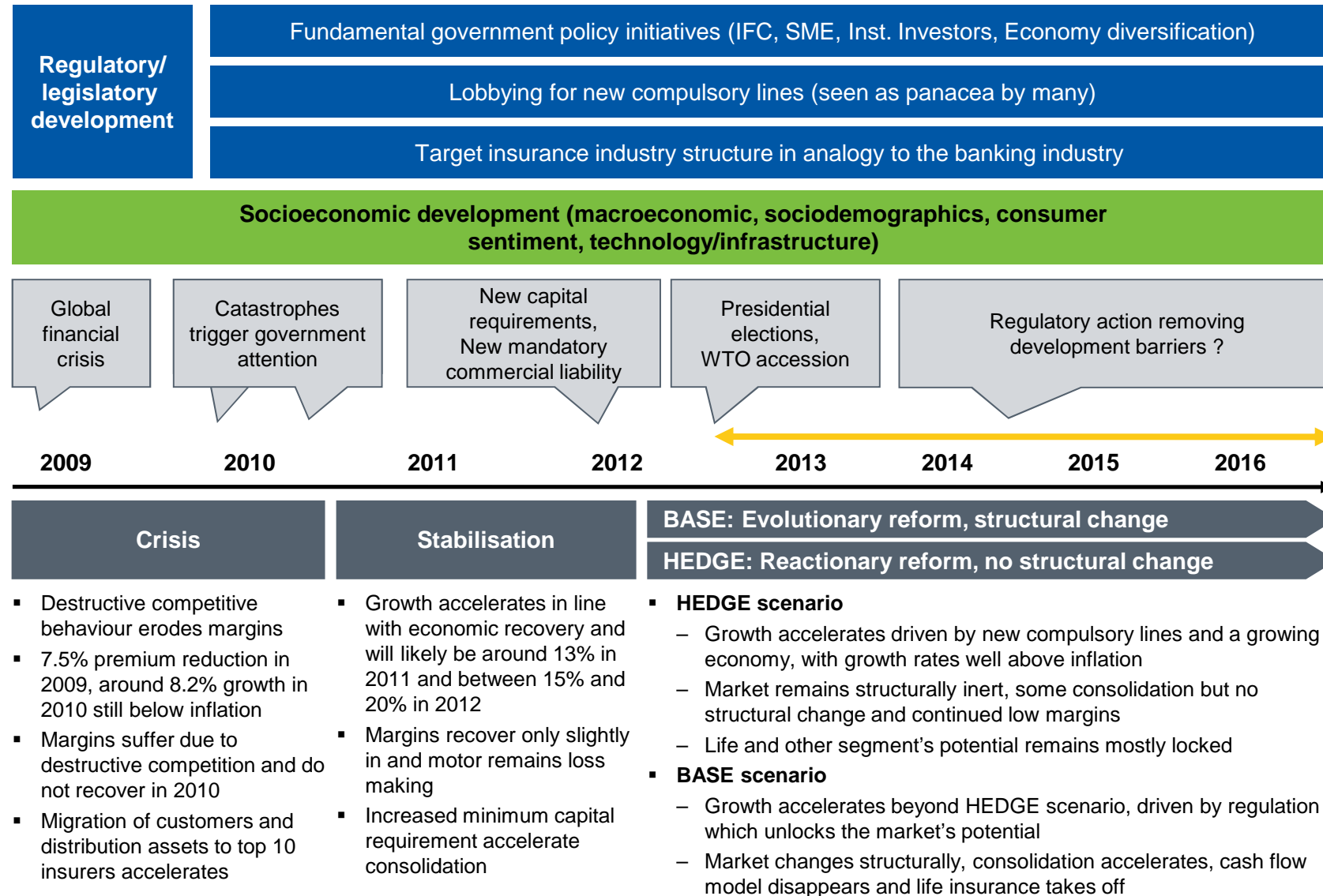
### Impact on market structure and dynamics

- Cash flow operating model is given a life-line and consolidation slows down
  - Some 500 insurers by 2013 and around 350 to 400 by 2016
- Market growth above 10% but below 20% (unless there is an economic boom) as growth is driven by underlying economic development alone and not by unlocking structural hurdles in the market
- Margin pressure remains high and premium increases are partly eaten up by inflation, meaning that GWP as percentage of GDP is rising only slowly
- 2016 Foreign share in insurance market remains similar to today

### Impact on investor sentiment

- Investor interest for investment in Russian insurance market recovers slowly, many strategic investors prefer other BRIC alternatives
  - Strategic investors will remain comparably hesitant
  - Some financial investors will want to take a bet, but IPOs at risk of failure
  - Market internal consolidation proceeds at slower pace
  - Valuations recover only slowly and remain below potential

## The development timeline is driven by external events and time required to formulate, pass and implement regulation – 2013 is where scenarios diverge



## Insurers believing in the BASE SCENARIO should plan along the following market development characteristics

	2009	2010	2011	2012	2013	2014	2015	2016
	Crisis		Stabilisation		Regulation triggers structural reform and improving margins			
<b>GWP growth</b>	-7.5% (CEO Survey predicted -7%)	8.2% (CEO Survey predicted 7%)	CEO Survey predicts 13%	CEO Survey predicts 20%	CAGR of 17% to 22%, with strong growth in Life (savings and pensions segment), but no boom			
<b>Margins</b>	Severe margin pressure	Severe margin pressure	Margin pressure eases only slowly	Margins (consolidation) improve but still under pressure	Margin recover and improve towards 2016 as a result of consolidation and disappearance of the cash flow operating model			
<b>No of players</b>	702	619	about 500	about 400	about 300	about 200		

Source: Oliver Wyman Insurance CEO Surveys 2009, 2010 and Oliver Wyman analysis

**However, Insurers should not discount the HEDGE SCENARIO in their planning which would result in significantly different industry economics**

	2009	2010	2011	2012	2013	2014	2015	2016
	Crisis		Stabilisation		Regulation does not trigger structural reform, margins under pressure			
<b>GWP growth</b>	-7,5% (CEO Survey predicted -7%)	8,2% (CEO Survey predicted 7%)	CEO Survey predicts 13%	CEO Survey predicts 15%	CAGR of about 12%, the life and savings market does not unlock, premium per risk hardly increases			
<b>Margins</b>	Severe margin pressure	Severe margin pressure	Margin pressure eases only slowly	Margins (consolidation) improve but still under pressure	Margins remain under pressure as growth above inflation allows cash flow operators to survive and destructive competition for volume continues			
<b>No of players</b>	702	619	about 500	about 400	about 350-400	about 350-400		

Source: Oliver Wyman Insurance CEO Surveys 2009, 2010, 2011 and Oliver Wyman analysis

## There are a number of trends driving the near term market development which hold in both development scenarios

### Accelerating consolidation

- The increased capital requirements which become effective on 1 Jan. 2012, will accelerate the migration of customers and distribution assets to large insurers
- The top 10 companies will be the clear winners in this process, other top 20 players will also benefit but to significantly lesser extent

### Low margins in Retail

- Competition on price and commissions is likely to continue in 2012
- Margins are unlikely to recover, profits are mainly generated by non-motor lines
- The CASCO segment is likely to continue to be overall loss making until regulatory reform improves the conditions for the Motor market

### Additional growth through new compulsory lines

- The introduction of new compulsory lines, for example the Mandatory Hazardous Objects Liability Insurance will add significant volume to the commercial segment
- However, one should expect that privileged access and captive-type relationships will capture the larger part of this new segment
- OMTPL tariffs are likely to be raised to adjust for inflation and increased coverage<sup>1</sup>

### Growth boost through lending recovery

- The general economic recovery has already led to a quick recovery of consumer lending which will lead to fast growth in:
  - Credit linked products
  - CASCO volume in a fast growing car market

### Build out of owned distribution channels

- Insurers intent to reduce their dependence on car dealers and broker, will build out direct distribution and try to get better control over their agent networks
- Bancassurance will become an even more important channel for insurers with significant long term potential in a future life and savings market

Source: Oliver Wyman Insurance CEO Survey 2011, Oliver Wyman analysis; (1) OMTPL tariff liberalisation (currently discussed) would open OMTPL to price differentiation

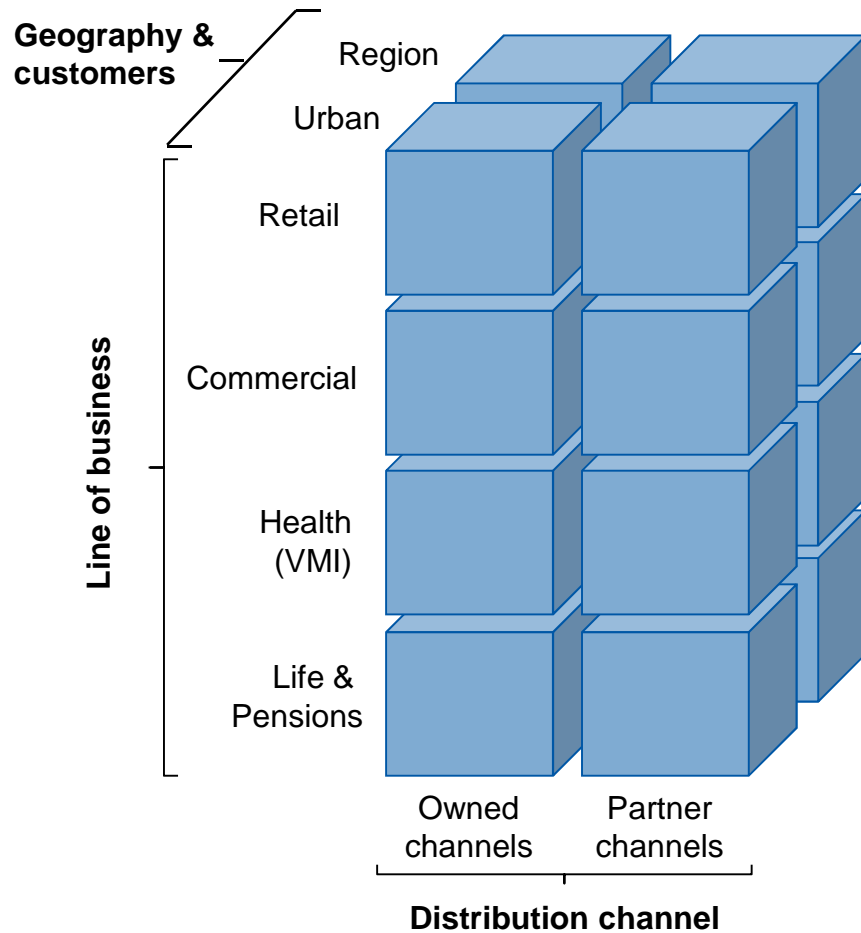
## However, there are a number of long term trends which have been observed in most markets and can be expected to eventually materialise in Russia as well

- Insurance markets follow specific development patterns, particularly in the areas of:
  - Market product and service structure
  - Market distribution structure
  - Bancassurance in the context of Life and Savings products which, depending on regulation, soften the boundaries between banking and insurance
  - Separation of business lines with significantly different operational requirements
    - Retail and Commercial
    - P&C and Health and Life & Pensions
    - Distribution partners and owned channels
  - Emerging business models
    - Universal players
    - Focused players (products / channels / customers / geographies)
    - Holdings of focussed business lines
- Applied to the Russian market, these patterns suggest the eventual formation of strategic blocks
  - Demarcation lines of these strategic blocks are already visible
  - The pace of their development will depend on the market development scenario, faster in the BASE SCENARIO and rather slow in the HEDGE SCENARIO

**These general trends need to inform the longer term strategic direction and successful companies will not base strategy on today's market observations alone**

Source: Oliver Wyman analysis

**We expect an increasing segregation of the market into strategic blocks, driven by sociodemographic development and differentiated success factors**



**Emerging strategic blocks along demarcation lines in the market**

- **Urban centres versus regions:** urban centre sociodemographics and economic development is faster than in the regions and will lead to quicker maturation of insurance in the large cities in terms of channel and product development
- **Owned versus partner channels:** direct, agents, banks, dealers, brokers, alternative channels all follow distinct KSF. Direct and tied agent allow ownership of customer while partners do not
- **Business lines with different KSF:** large commercial requires a professional services approach, retail is a unit cost game (factory), Life/Pension requires particular risk and asset management skills and Health requires access to healthcare infrastructure and ability to control cost

Source: Oliver Wyman analysis

**With only few insurers being in a position to build credible positions in all strategic blocks, second tier players will have to decide on where they want to focus**

Universal Insurer	Focussed strategy around specific strategic blocks			Holding of focussed businesses
	Product	Region	Channel	
<ul style="list-style-type: none"> <li>▪ Top 3 or 5 player</li> <li>▪ Present in all regions, channels and products (but not necessarily large commercial)</li> <li>▪ Brand is a household name with customers and distribution partners</li> <li>▪ Not necessarily the most efficient operator due to complexity, but benefiting from scale effects</li> <li>▪ Willing to “buy” market share if sustainable</li> </ul>	<ul style="list-style-type: none"> <li>▪ Smaller player focused on one or more products</li> <li>▪ Excellent execution and customer service for chosen product (e.g. service agreements with partners)</li> <li>▪ May perform more activities in product segment than insurance (e.g. car recovery network, garage network, home emergency service)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Smaller player focused on one or more regions</li> <li>▪ Branding as regional partner; may require investing in region (e.g. sponsorship, moving back office to regions etc.)</li> <li>▪ Most products and channels serviced in region</li> <li>▪ Excellent customer service and very fair claims handling to support “regional partner” brand</li> </ul>	<ul style="list-style-type: none"> <li>▪ Smaller player focused on one or more specific channels (e.g., direct, bancassurance)</li> <li>▪ Detailed understanding of success factors in channel and outstanding execution and service in channel (e.g. education, support and infrastructure for distribution partners)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Can be a top player</li> <li>▪ Present in several products, channels and regions                             <ul style="list-style-type: none"> <li>– Strong position in main strategic blocks of the market, but not all</li> </ul> </li> <li>▪ Brand is well known amongst target customers, certainly among distribution partners</li> <li>▪ Focused on profit over market share</li> </ul>

Source: Oliver Wyman analysis

## Insurers who ignore these longer term trends do this at their own peril

- **Market leaders** who do not professionalize along the strategic blocks will eventually find themselves challenged by focused second tier players with better value propositions to customers and distribution partners based on better aligned operating models
- **Second tier players** who do not establish strategic focus and try to serve everything and everyone will find that they cannot achieve the economics of scale to remain credible competitors to focussed 2<sup>nd</sup> tier players and large universal players
- **Players depending on captive business or some sort of privileged access** to costumers and distribution partners should prepare for market reform which will eventually erode their privileged positions or risk to loose out against open market players
- **Insurers which do not prepare for the take-off of life insurance** will not be able to establish strong positions in the life and pensions segment once the life market starts to take off. There is good reason to believe that the Life and Pensions segment will be dominated by bancassurance. Establishing a well working bancassurance partnership requires to go through a learning curve and takes time
- **Insurers who do not reform their agent networks** will see themselves struggle to compete with younger and more modern agent network structures. The typical Russian agent network is demographically challenged and ineffective in selling more complex products than OMTPL and CASCO. There are alternative models which allow insurers more control over customers and achieve higher sales per agent, to the advantage of the company and agents as well
- **Insurers who do not address their back-office cost** will be at a strategic disadvantage, particularly in retail which will become more and more a unit cost game

Source: Oliver Wyman analysis

4

**Synthesis and Oliver Wyman  
perspective**

**4.2 Owner / investor / CEO perspective**

## The owner's perspective – what are your choices?

### Go it alone?

- Are you committed to be in insurance for the long term?
- Do you have the financial resources to support the operational professionalisation of your business?
- Can you secure the managerial and technical skills to transition the company out of the cash flow underwriting model?

### Invite a partner?

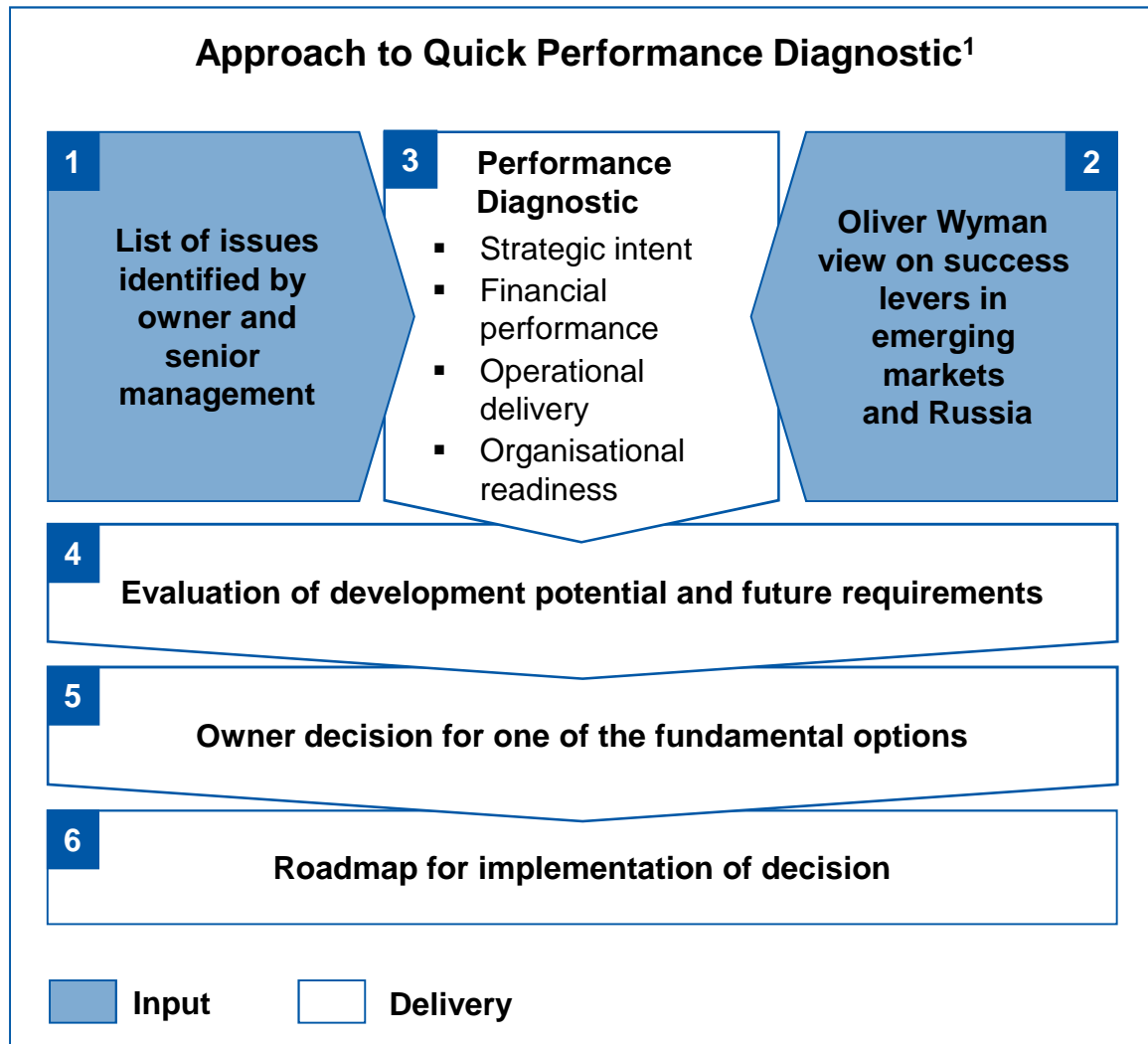
- If capital is the main issue, can you partner with a financial investor?
- If you need capital and managerial and technical skill support, can you partner with a strategic investor?
- How can you make your company more attractive for investors?
- What is your investor engagement strategy?

### Divest?

- Who are potential buyers and what price can you hope to achieve?
- How do you prepare your company for divestment?

Source: Oliver Wyman analysis

## The owner's perspective – what action shall you take?



- Doing a holistic assessment of your company's situation is the best way to prepare for fundamental decisions
- A Quick Performance Diagnostic is a way to do an assessment within 3 to 5 weeks at a comparably low cost
- The results provide a realistic outlook for your company's prospects and the amount of investment required to achieve your strategic aspiration
- It is also often applied to adjust strategic ambition and define an investor approach strategy

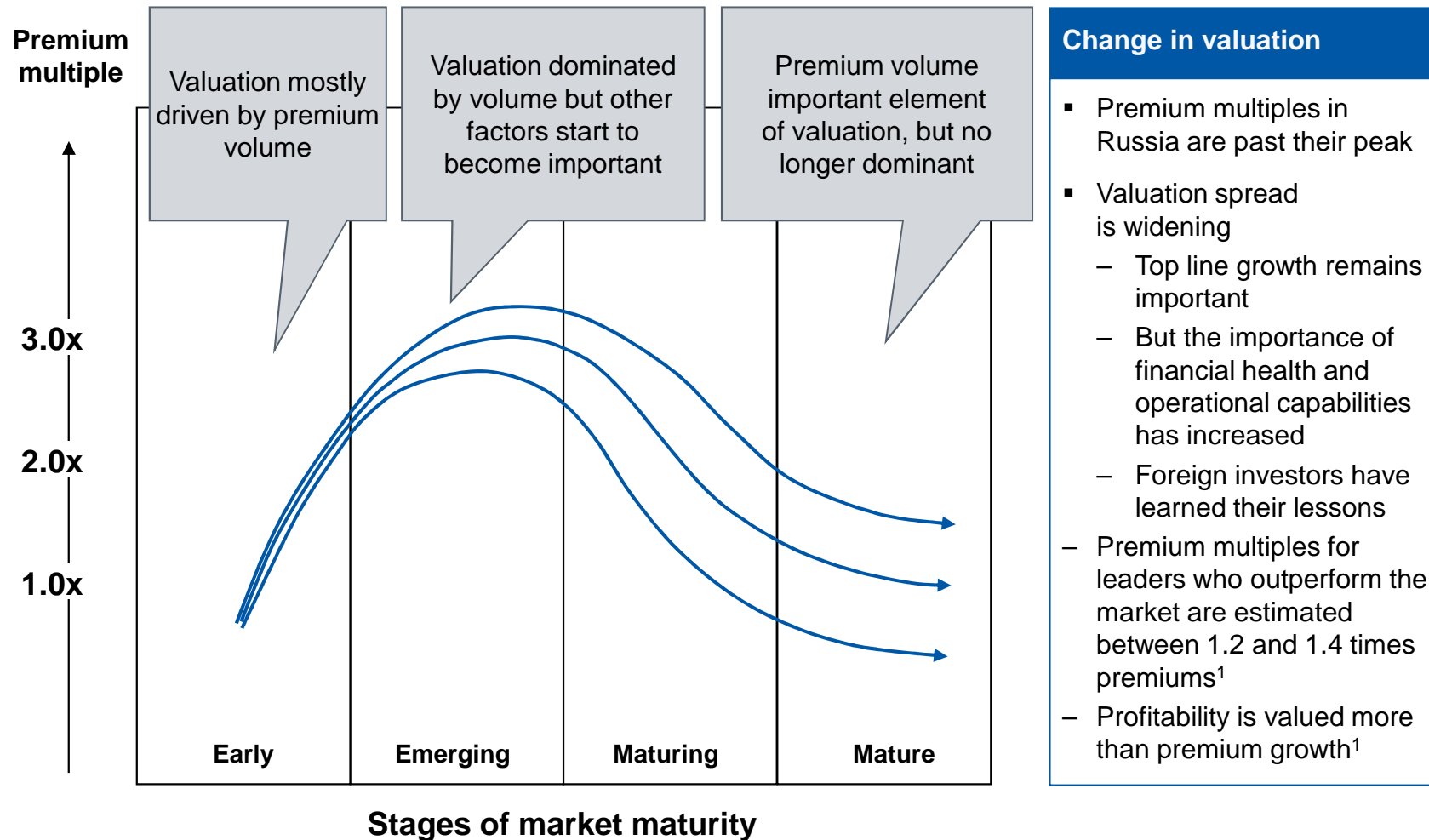
Source: Oliver Wyman Quick Performance Diagnostic Approach and Tools

<sup>1</sup> The Quick Performance Diagnostic is done within 3 to 5 weeks and creates a holistic and strategically highly relevant fact based assessment along the whole value chain

## The owner's perspective: Be realistic, the high pre-crisis premium multiples will not return

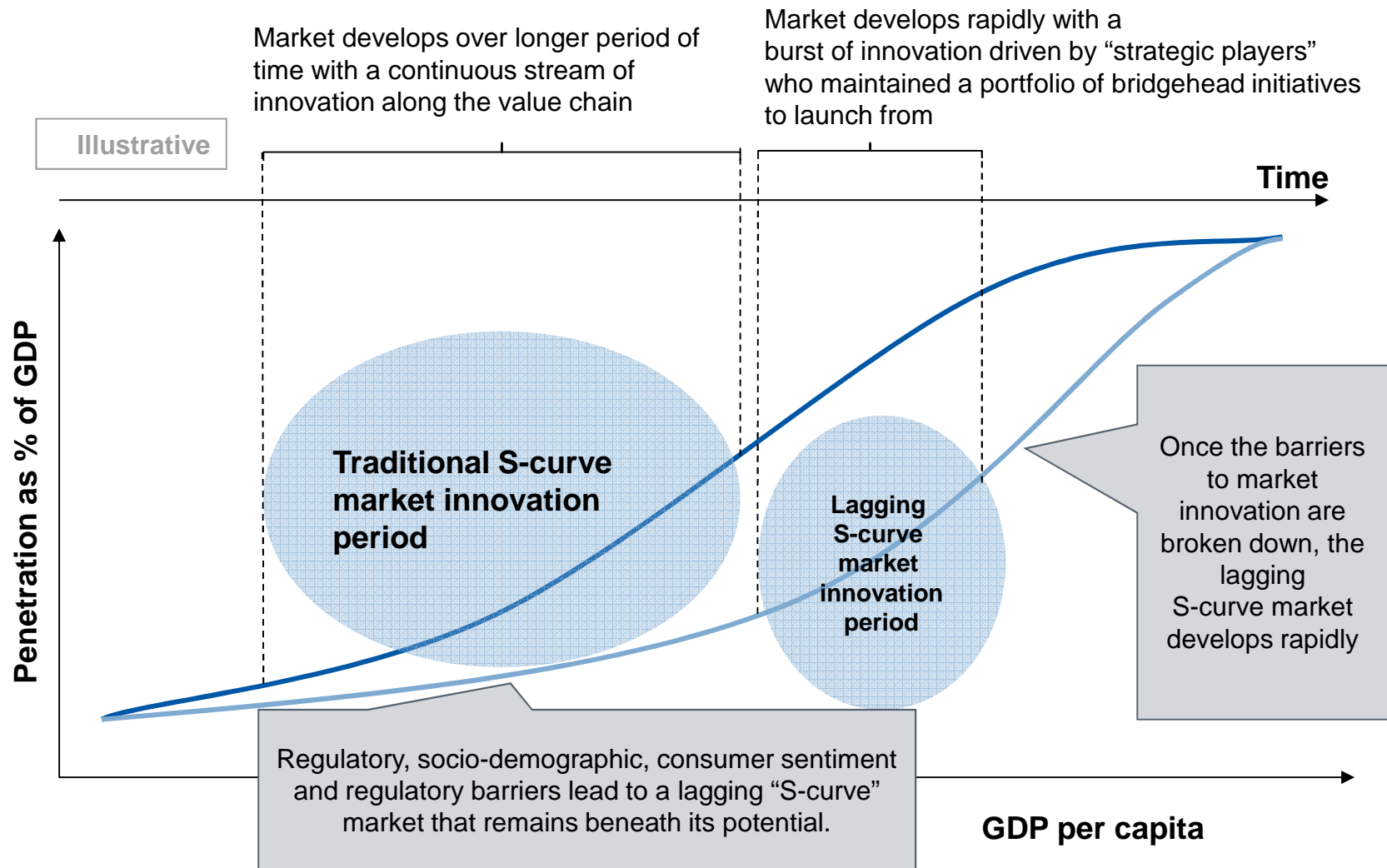
### Illustration of premium multiple valuation development

Illustrative



Source: Oliver Wyman analysis  
1 Russian Insurance CEO Survey 2011

## The investor's perspective: The "lagging S-curve" structure of the Russian insurance implies significant long term potential



Source: Oliver Wyman analysis

## Foreign investor interest has started to pick up and will intensify if progress on the regulatory framework seems likely

### Mid 2008: Investors have been bullish

- 1 Size: Largest CEE market
- 2 Growth: Strong and continuous
- 3 Margins: Reasonable, some emerging concerns
- 4 Analysts: Valuing position in growth market
- 5 Shareholders: Want to secure position in growth markets

### 2009: Investor's have been negative

- 1 Size: Largest CEE market, but relatively small and Russia weakest BRIC
- 2 Growth: Negative in 2009, flat in 2010
- 3 Margins: Under severe pressure, some lines loss-making
- 4 Analysts: Downgrade and negative outlook
- 5 Shareholders: Risk adverse, and cautious with longer term views

### 2010 / 2011: Investor interest is starting to return and will intensify if reform looks likely<sup>1</sup>

#### Strategic investor include

- One of the largest insurers globally
- A large European composite Insurer
- A large European bancassurer

#### Finance investors include

- Several mid market PE funds
- Two large global PE funds

Source: Oliver Wyman analysis

1. Current capital quota (25%) for foreign insurers is almost reached making further investment difficult unless regulation changes

## The CEO's perspective: Strategic focus and professionalisation

<p><b>Define your strategic focus</b></p>	<ul style="list-style-type: none"> <li>▪ Agree with your shareholder on a realistic market development story and a frank view of your competitive position</li> <li>▪ Agree with your shareholder your strategic focus and if required adjust your strategic aspiration to what is realistically achievable</li> <li>▪ Decide on whether you are seeking investor or strategic partners and if so, define the timeline and approach</li> <li>▪ Do a “Quick Performance Diagnostic” to have a baseline</li> </ul>	<p><b>Now</b></p>
<p><b>Improve near term financial results</b></p>	<ul style="list-style-type: none"> <li>▪ Increase marketing effectiveness</li> <li>▪ Scale up distribution capabilities (particularly your agent capabilities)</li> <li>▪ Improve overall channel effectiveness</li> <li>▪ Reduce exposure to unprofitable market segments and channels</li> <li>▪ Address obvious leakage in claims</li> </ul>	<p><b>6 months</b></p>
<p><b>Professionalise your operations</b></p>	<ul style="list-style-type: none"> <li>▪ Improve quality and integrity of technical functions             <ul style="list-style-type: none"> <li>– Underwriting</li> <li>– Claims</li> </ul> </li> <li>▪ Get serious on “owning” your distribution</li> <li>▪ Improve efficiency of other back office functions</li> </ul>	<p><b>1 years</b></p>
<p><b>Transition out of the cash flow operating model</b></p>	<ul style="list-style-type: none"> <li>▪ Introduce IFRS accounting and economic “shadow metrics”</li> <li>▪ Give shadow metrics increasing weight in executive remuneration</li> <li>▪ Define strategic financial corridor to balance growth and profitability</li> </ul>	<p><b>2 years</b></p>

Source: Oliver Wyman analysis