

KPMG IN RUSSIA AND THE CIS

New reality: the Russian insurance market

July 2014

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Introduction



KPMG presents the fifth annual survey of the insurance industry in Russia. This survey summarizes current market trends, analyses anticipated changes and benchmarks them against our previous findings.

Russian insurance companies faced a new reality in 2014. A slowdown in market growth is a response to the worse macroeconomic situation in the country. Economic recession had a negative impact on the market drivers such as purchasing power, credit lending and activity on the car sales market.

Under the current unfavorable market conditions, CEOs are focused on profitability maintenance through such ways of cost reduction as portfolio quality improvement and avoiding unprofitable portfolio growth (especially in loss-making regions). Market leaders perceive the current environment with calm, so they are looking for more opportunities to capture additional market share, while smaller players, not having enough capital, are doing their best to avoid bankruptcy or license revocation.

Regulatory changes are affecting the Russian insurance market in different ways. On the one hand, the expansion of the Consumer Protection Law on the insurance industry and expansion of CMTPL limits resulted in a significant increase in motor insurance loss ratios. This was caused not only by legitimate claims, but also by insurance fraud and heavy court charges. These factors put an additional pressure on insurers and forced them to raise rates and limit sales. On the other hand, the expansion of CMTPL limits provides grounds for rate increases, thereby improving loss ratios. The introduction of a new "megaregulator" under the Central Bank of Russia can be considered as another positive regulatory change. Most of the respondents expect positive developments in market regulation in the coming years.

We hope that the findings of our survey will be beneficial to you and will help to determine the future development of your business. We also take this opportunity to thank our colleagues, who contributed to this survey, and all the respondents, who were willing to participate and made the survey possible.

Best regards,

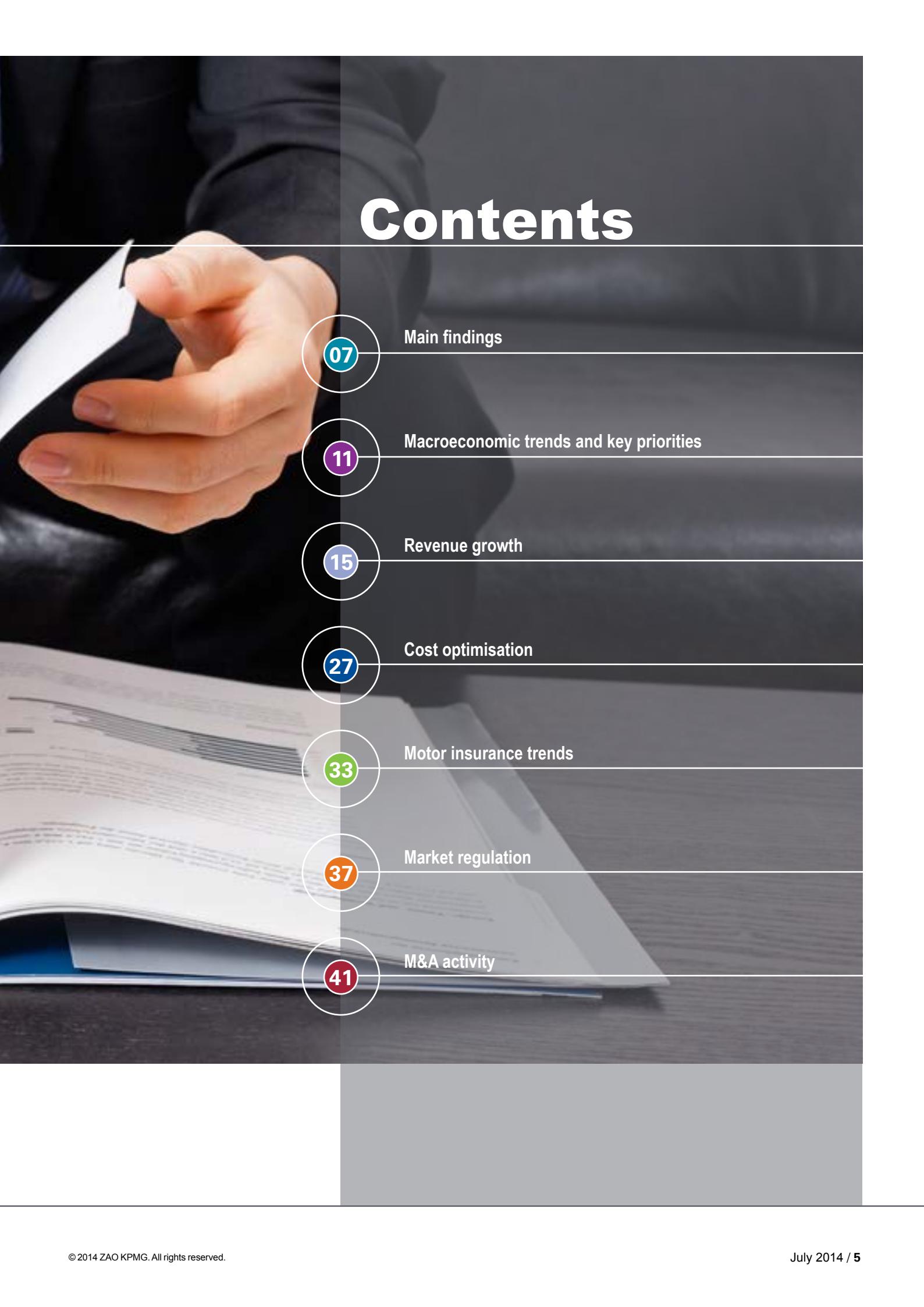
Adrian Quinton

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Contents



- 07 Main findings
- 11 Macroeconomic trends and key priorities
- 15 Revenue growth
- 27 Cost optimisation
- 33 Motor insurance trends
- 37 Market regulation
- 41 M&A activity





Main findings



Market growth slows down despite the double digit rate increase in life insurance sector

Our respondents predict deceleration of the Russian insurance market growth rates in 2014. All of the products, other than life insurance, are expected to show less than 10% growth, whereas, the life insurance market will increase by 18% due to expansion of the mortgage lending. However, this segment accounts for a relatively small part of the total voluntary insurance, and consequently it will not have a material impact on the development of the insurance market as a whole.

The slowdown in insurance market growth is mainly attributed to the economic situation in the country. Besides the direct effect of negative client expectations of a possible economic recession, insurance market trends are closely related to purchasing power and credit lending, which are highly correlated to the economic environment.



The number one objective is to stay profitable

Against the backdrop of macroeconomic stagnation verging on recession, Russian insurance companies are taking measures to stay profitable and remain attractive. The majority of market players are taking time out as they are waiting to see how the developments unfold. The leaders of the insurance sector are trying to adhere to long-term strategies and optimize business processes by increasing profitability through staff reductions and wage cuts. Smaller market players have to "tighten their belts" that could lead them to serious negative circumstances.

Furthermore, insurers are placing high hopes on the bill that regulates on-line sales of insurance policies becoming a law. Implementation of such an innovative sales channel will enable insurance companies to reduce acquisition costs and staff expenses.

Costs reduction and rates increase are key measures to maintain profitability

Insurers expect the average loss ratios for all lines of business to be higher in 2014 compared to 2013. As was the case last year, Casco, CMTPL and VMI will remain the least profitable lines. Liability insurance and Accident insurance are expected to be the most profitable products. Property insurance is less attractive than a year ago, which is likely to be caused by high loss ratios in respect of insurance of hazardous facilities.

Among the methods aimed to reduce the cost of claims in 2014 the respondents single out business relationships improvement and rate increase.

As in 2013, a priority area for insurers in 2014 is cutting administrative and acquisition costs. Optimisation of the existing corporate structure and implementation of new business models are the key ways of administrative costs reduction. Meanwhile, the respondents are going to cut acquisition costs through the development of on-line sales.

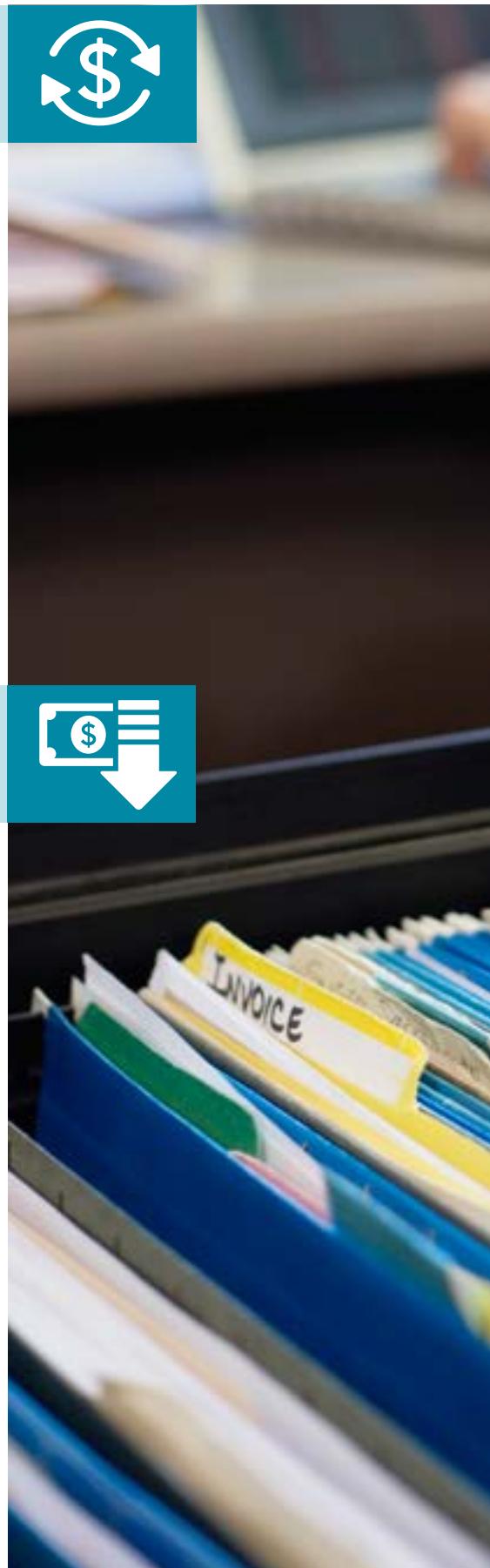


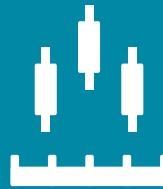
Motor insurance loss ratios are on the rise

The expansion of the Consumer Protection Law on the insurance industry had an adverse impact on the motor insurance, causing the rise of loss ratios. The increase in fraudulent claims and court charges are the main reasons for this trend.

90% of respondents confirmed the significant share of claims settled under the Consumer Protection Law to be fraudulent. However, insurers prefer to wait for progressive anti-fraud measures proposed by regulator rather than initiate actions to tackle the fraud themselves.

The majority of insurance executives, who took part in this survey, are going to reduce the loss ratios regarding motor insurance portfolios by increasing rates and limiting sales in loss-making regions. Almost a half of the respondents would like to have no tariff regulation for CMTPL pricing, this would enable them to reduce loss ratios in respect of motor insurance.





Players welcome the establishment of the “megaregulator”

Insurers consider the establishment of the “megaregulator” under the Central Bank of Russia to have a positive effect on the market. However, there are a lot of areas that require additional legislative regulation and supervision, such as pricing policies, capital adequacy and development of on-line sales.



M&A: consolidation is expected

According to the respondents, in each segment of the insurance market there are companies close to bankruptcy or license revocation.

Our respondents predict consolidation of the insurance market in 2014, particularly they expect M&A events among top 10 companies.





Macroeconomic trends and key priorities

Measures which are likely to be taken by insurers given the macroeconomic situation in the country changing for the worse



Source: KPMG analysis.

The majority of insurers are going to reduce their costs given declining economic environment. Personnel costs and other operational expenses will be reduced to a greater extent. Companies, which pursued a less aggressive policy during the growth period and set aside a sufficient capital to overcome stagnation and recession periods, are cutting their budgets to a lesser degree.

Insurance executives point out a reduction of acquisition costs as the other anti-crisis measure. The development of new distribution channels such as on-line sales is a possible way to decrease acquisition costs. The bill that regulates on-line sales was approved in the third reading in May 2014 and was submitted for review to the Council of the Federation.

Cost cutting is a prevailing reaction of the insurance market to the worsening macroeconomic situation.

Priority areas of development



Source: KPMG analysis.



Over the last three years profitability management has remained a key objective, however, the other insurers' priorities have been changed due to the worsening economic situation.

In 2014 insurers' principal priorities are cost cutting and increasing the level of customer retention, whereas in 2013 they were focusing on revenue per client growth (by insurance services quality improvement) and increase of the number of written policies (by attracting new clients). Optimisation of distribution channels remains one of the key priorities in 2014.

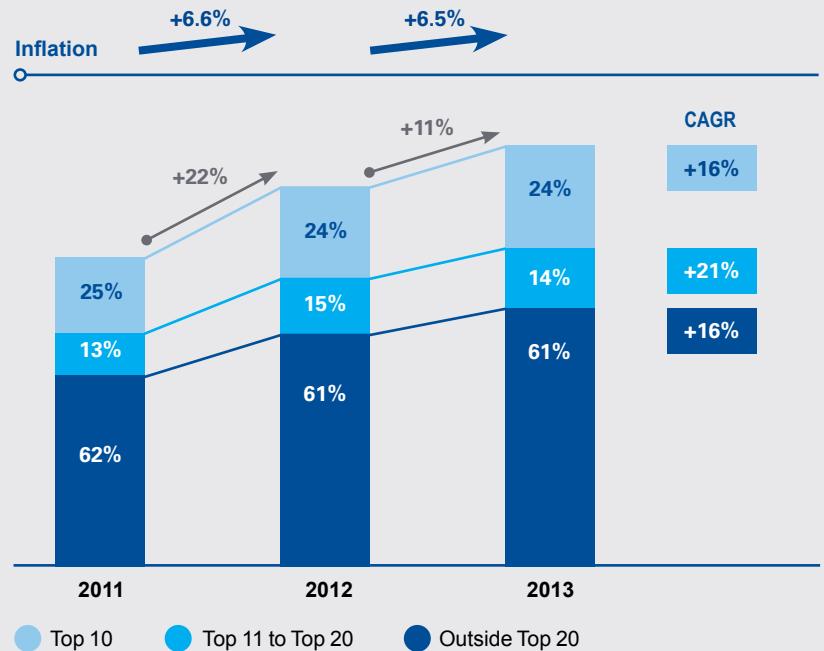






Revenue growth

Insurance market dynamics per market segment



Note: Percentages may not add up to 100 percent due to rounding.

Source: Central Bank of Russia.

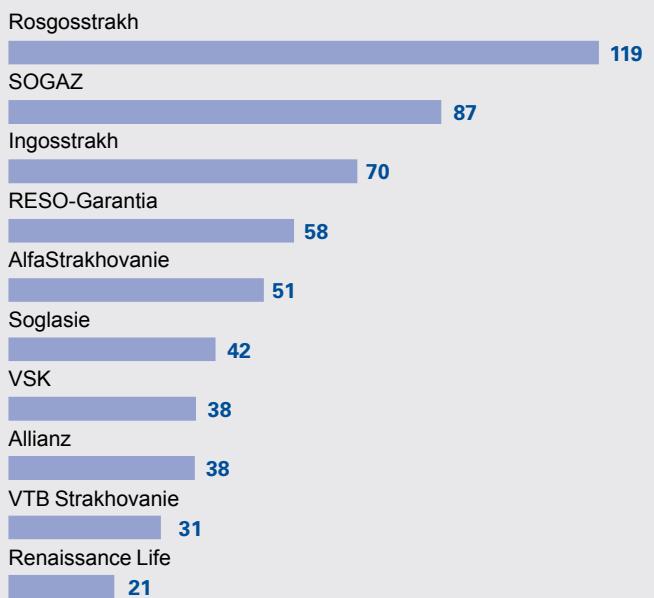
The growth of the insurance market has slowed down in 2013 due to a decrease in growth rates for both market leaders and smaller participants. The actual decrease in growth rate was slightly more than expected. At the beginning of 2013 insurers expected a decrease in growth rate down to 12% (KPMG

Survey: *Rewarding risk: the Russian insurance market in 2013*). However, the actual pace of growth was 11% in 2013. The respondents anticipate a further slowdown in the growth rate to 2–7% p.a. in 2014.



Top 10 Russian insurers by gross written premium

(RUB bl)



Company	Market share	Change in market share from 2013
Rosgosstrakh	13.2%	(1.0)%
SOGAZ	9.6%	(0.2)%
Ingosstrakh	7.8%	(1.0)%
RESO-Garantia	6.4%	(0.0)%
AlfaStrakhovanie	5.7%	0.7%
Soglasie	4.6%	0.5%
VSK	4.2%	0.1%
Allianz	4.2%	0.5%
VTB Strakhovanie	3.4%	0.6%
Renaissance Life	2.4%	(0.2)%

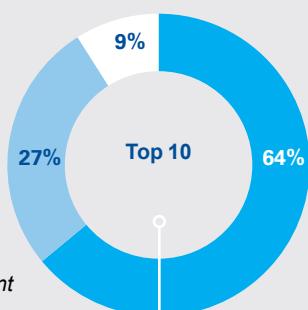
Source: Central Bank of Russia.

In 2014 market consolidation attributed to a reduction of smaller participants' share is expected.

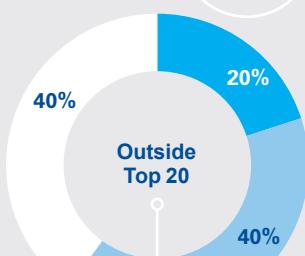
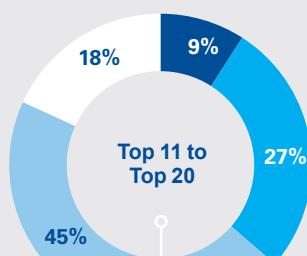


Expected increase in gross written premium in 2014 per market segment

- 15–20%
- 5–15%
- 0–5%
- Decrease



Note: Percentages may not add up to 100 percent due to rounding.



Expected growth in 2014

+7%

+5%

+2%

Expected growth in 2013

+13%

+13%

+6%

Actual growth in 2013

+11%

+5%

+15%

Source: KPMG analysis.

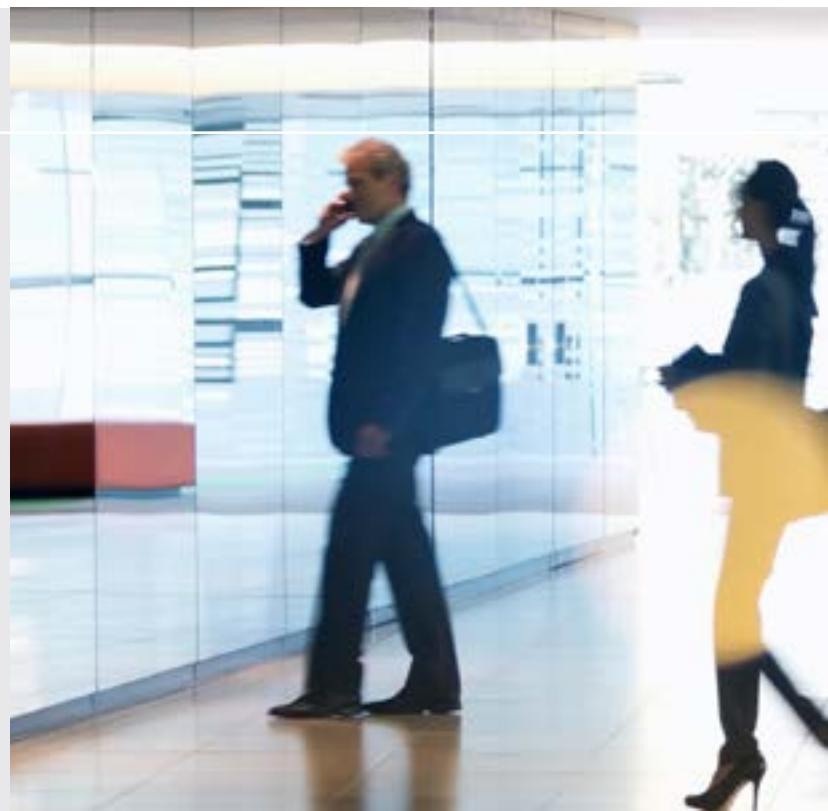
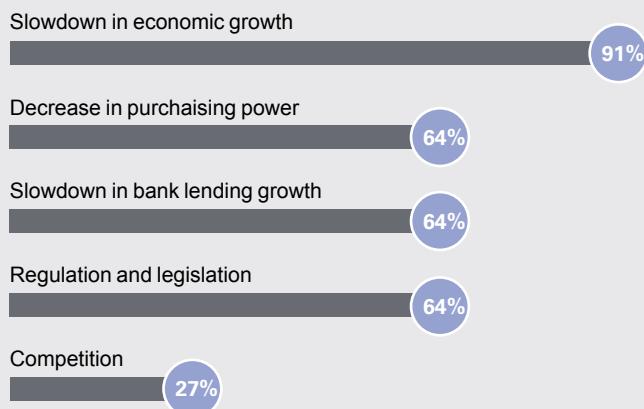
There were no significant changes in the insurance market structure in 2013. However, in 2014 market consolidation is likely to happen due to the reduction of market share of small and medium insurance companies attributed to:

- lack of resources as a result of cashflow underwriting in the past now leading to losses;
- increasing loss ratios.

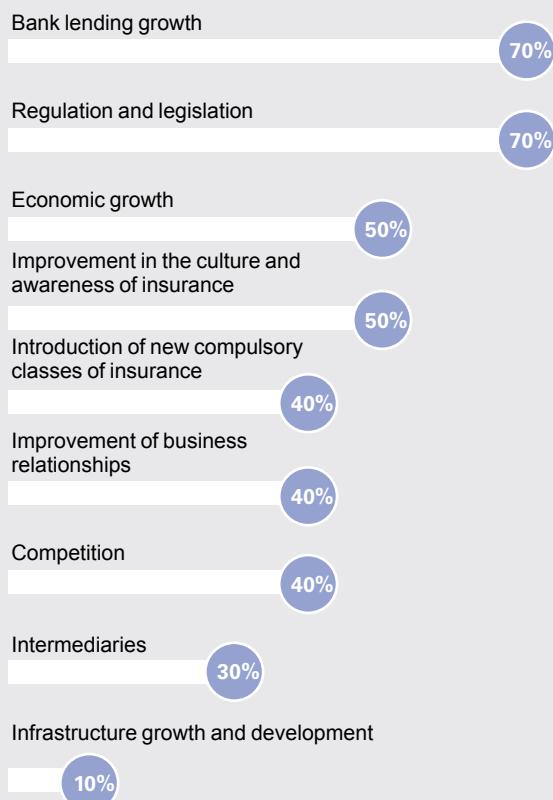
The insurance market participants expect the market to grow purely due to the leaders of the industry.



Insurance market drivers in 2014



Insurance market drivers in 2013



Economic environment mainly defines the shape of the Russian insurance industry in 2014, whereas the other factors are sidelined.

A slowdown in economic growth negatively impacts the insurance market due to:

- reduction of spending on insurance;
- decrease in demand in the insurance related areas of the market.

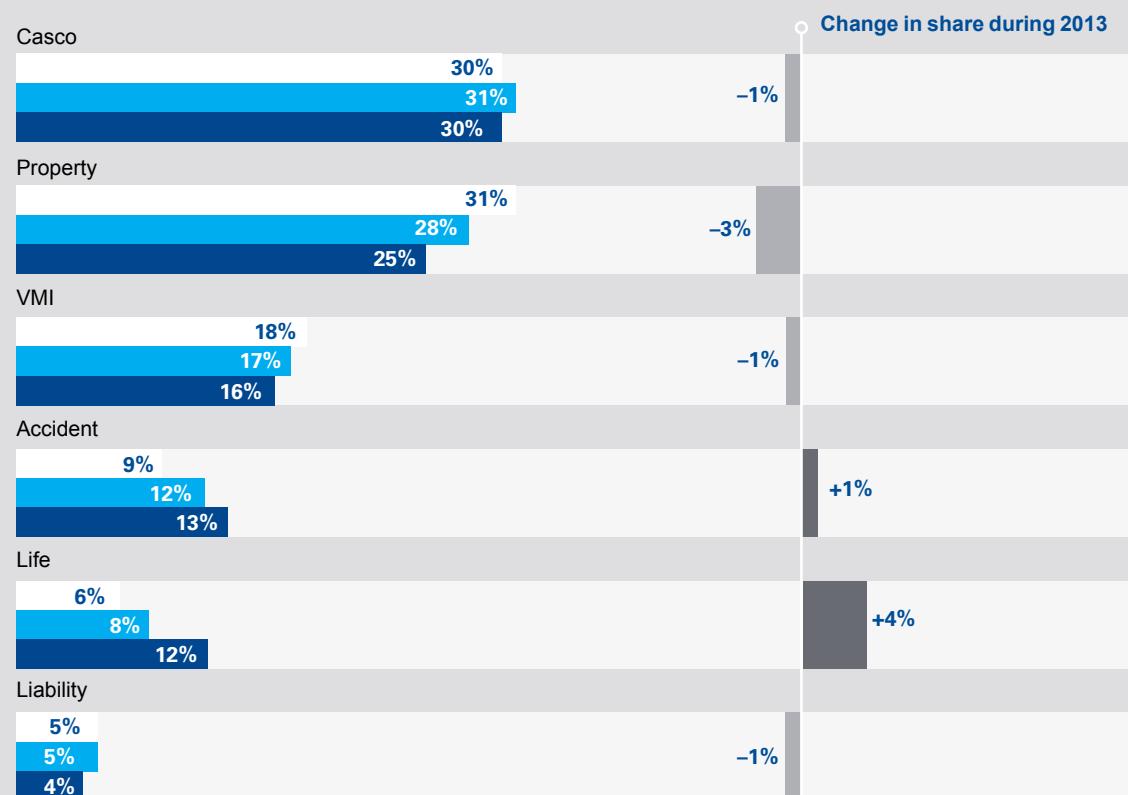
A slowdown in consumer lending is reflected in insurance growth deceleration. The actual growth rate in retail lending (21%* in the year 2013) turned out to be 1.5 times lower than the rate projected by the Central Bank of Russia (30%). Moreover, a 6% fall ** in car sales in 2013 has also affected the insurance market growth rate. Besides, legislative reforms remain one of the key factors affecting the insurance market, as it was in 2013.

* Source: Central Bank of Russia.

**Source: Association of European Business http://aebrus.ru/upload/iblock/c42/sales-in-november_rus_final.pdf



Premium share dynamics in 2011–2013 by key insurance market segments



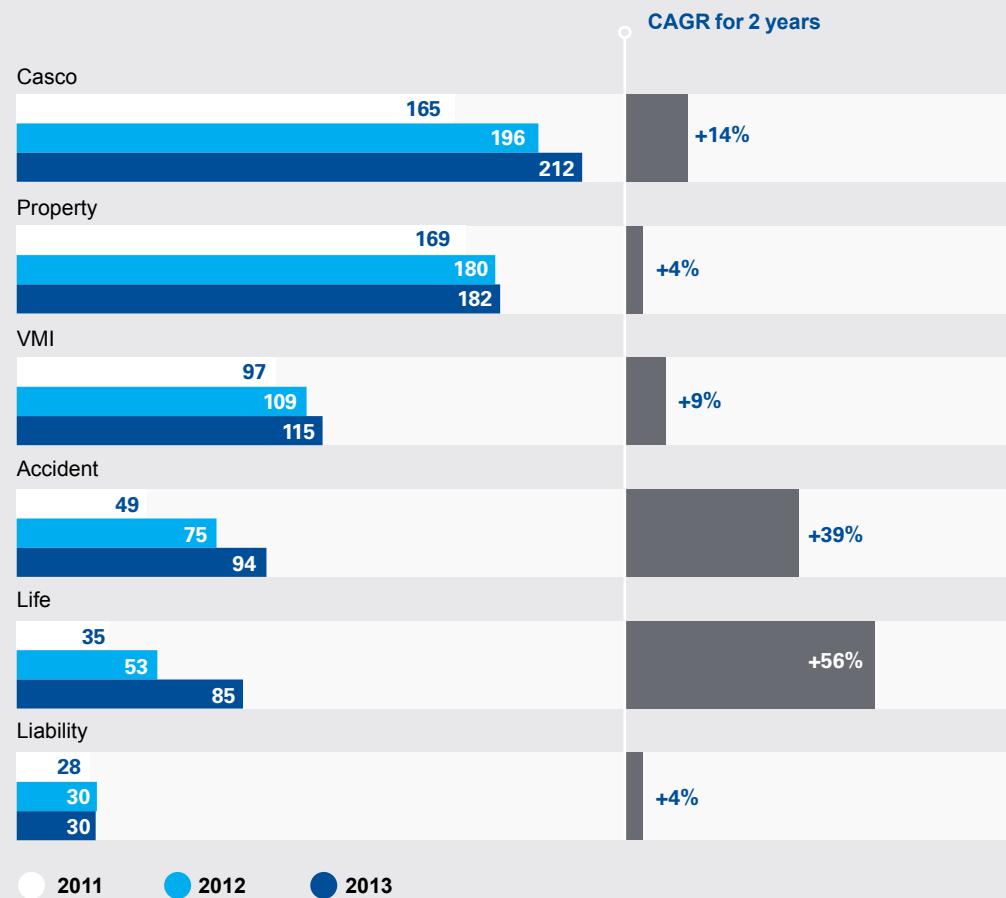
Source: Central Bank of Russia, KPMG analysis.

One of the main factors that contributed to the increase of life insurance share from 6% (2011) to 12% (2013) is the market entry of Sberbank Strakhovanie, which receives strong support from its parent company in terms of resources and sales channels and in terms of brand awareness.

Life and accident insurance have increased their shares in voluntary insurance market during the last three years.

Gross written premium dynamics by key insurance market segments

(RUB bl)



Source: Central Bank of Russia, KPMG analysis.

Life insurance and accident insurance became the fast-growing segments with 56% and 39% increase respectively.

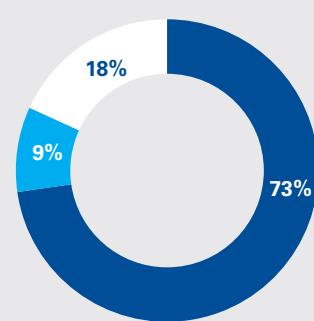
These fast-growing segments account, however, for a relatively small share in the total voluntary insurance market. Consequently, they do not have a significant impact on the growth of insurance market as a whole.

The increase in credit life and accident insurance is largely the result of the growth of mortgage lending. Further growth in life and accident insurance could be expected in 2014 due to a continuous growth in the mortgage lending market (more than 10%* in 2014). However, high dependence of life and accident insurance on mortgage lending may become a risk factor in case of legal restrictions in this area. In the long-term strategies insurance companies should focus on endowment and pension insurance products.

Liability insurance did not show a significant growth in 2013, in spite of the fact that insurance companies expected the largest growth in this particular segment at the beginning of 2013. A decrease in liability insurance premiums is attributed to the fact that some regions have lost their attractiveness as potential VMPL market.

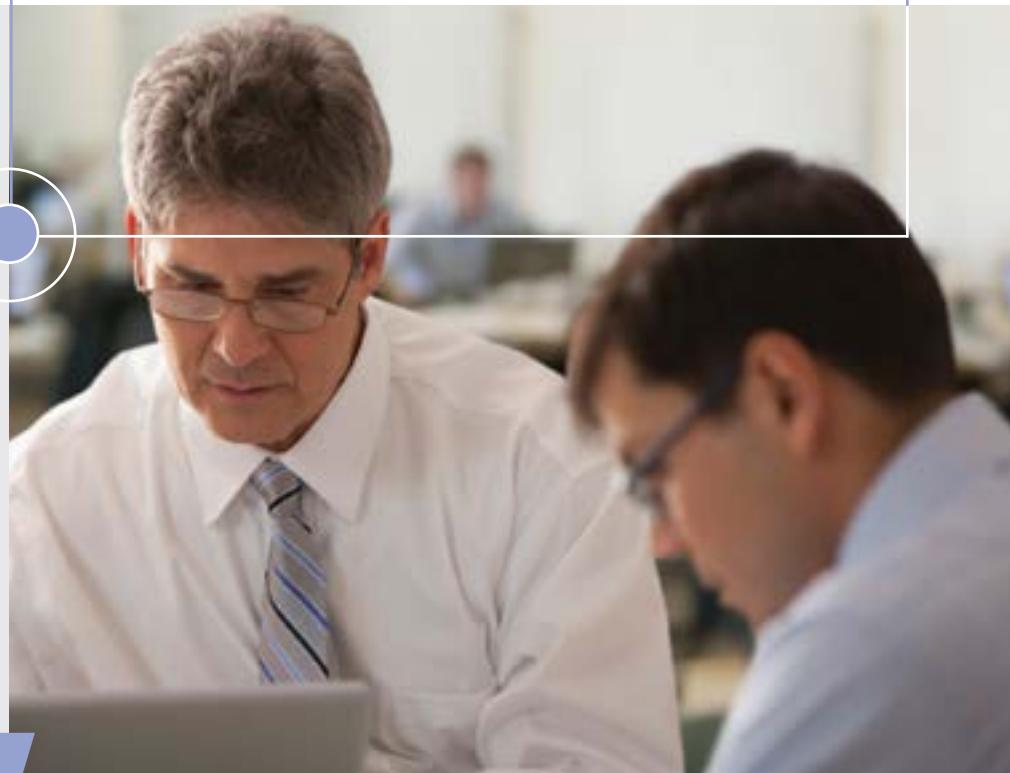
Liability insurance did not show a significant growth in 2013.

Outlook for the non-life insurance market growth in the short term perspective



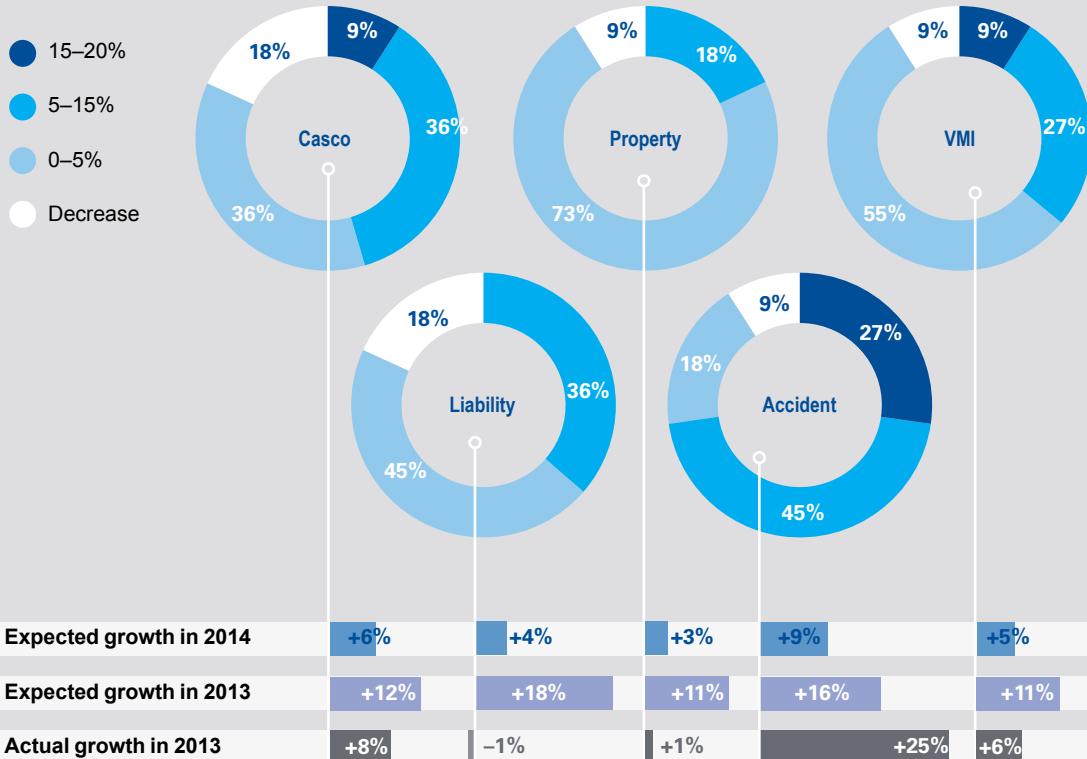
- Slow growth (less than 10%)
- Stagnation
- Decrease

Source: KPMG analysis.



*Source: KPMG analysis.

Expected premium growth in 2014 per segment



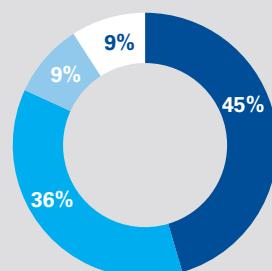
Note: Percentages may not add up to 100 percent due to rounding.

Source: KPMG analysis.

The projected premium growth was not realized in 2013 in respect of all lines of business except life and accident insurance. Market participants are expecting a significant slowdown in growth rates of voluntary insurance products which are highly sensitive to price, such as property insurance.



Outlook for the life insurance market growth in the short term perspective



● Growth will slow to 20-40%

● Growth will slow to 5-20%

● Stagnation

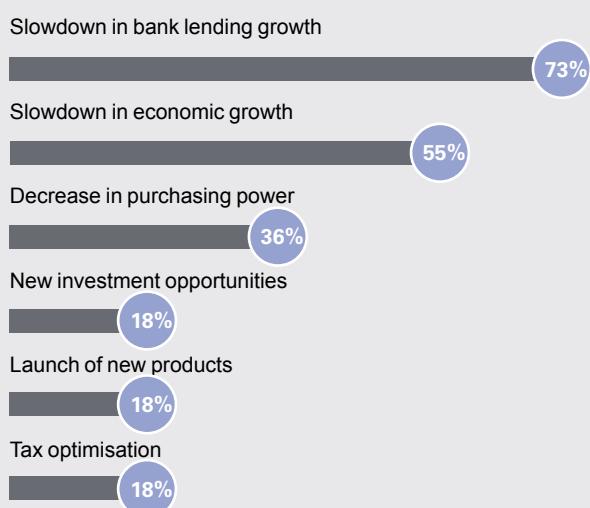
● Difficult to say

Note: Percentages may not add up to 100 percent due to rounding.

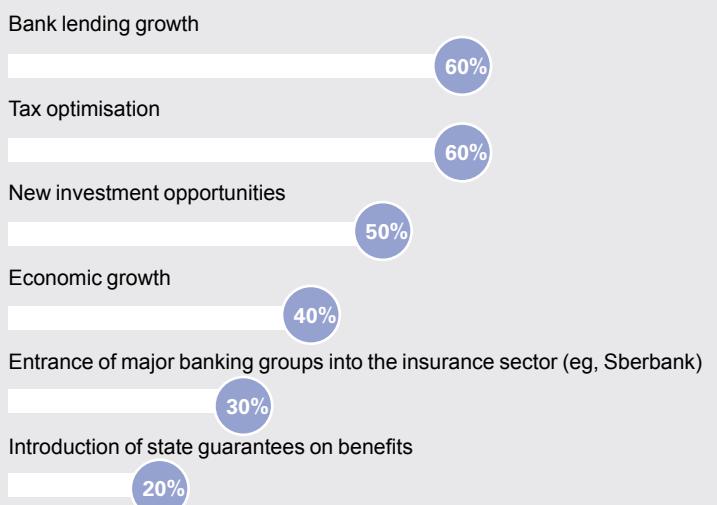
Source: KPMG analysis.

The majority of respondents anticipate a slowdown in life insurance market growth rate. However, according to the respondents' forecast, it could reach 20%. The reason for this is the dynamic development of the mortgage lending, which significantly affects the increase.

Life insurance market drivers in 2014



Life insurance market drivers in 2013



Source: KPMG analysis.

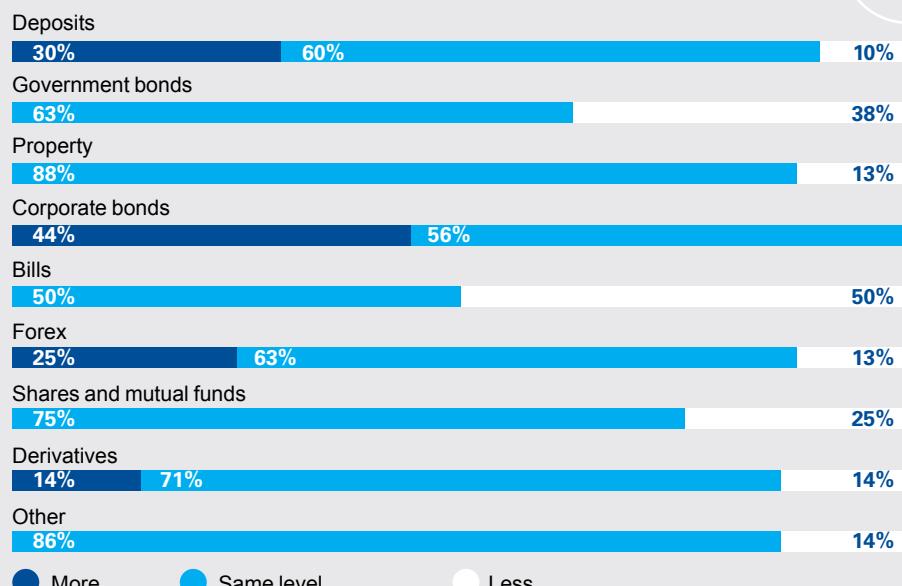
In 2014 the most influential factor for life insurance as well as other market segments will be the economic situation in Russia, while the other factors are most likely to be secondary.

Bank lending is the key driver of life insurance market in Russia. Thus, the market shape is skewed towards credit life, while such traditional types of insurance as endowment and pension are slowly developing.





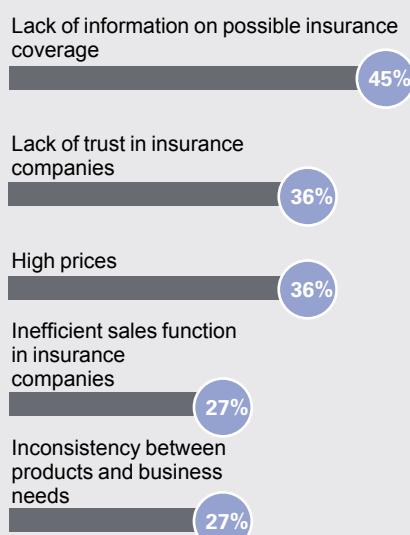
Preferred investment policies in 2014



Note: Percentages may not add up to 100 percent due to rounding.

Source: KPMG analysis.

Main reasons for low insurance penetration among small and medium enterprise (SME)



Source: KPMG analysis.

Insurance executives are planning to maintain current investment strategies and review investment priorities in favour of corporate bonds.

The SME continues to be the sector with a low level of insurance penetration. The main reasons for this are a lack of information about possible insurance coverage and a lack of trust in insurance companies due to a low level of insurance culture of potential customers. The possible measures to increase the level of insurance penetration among SME's are the following:

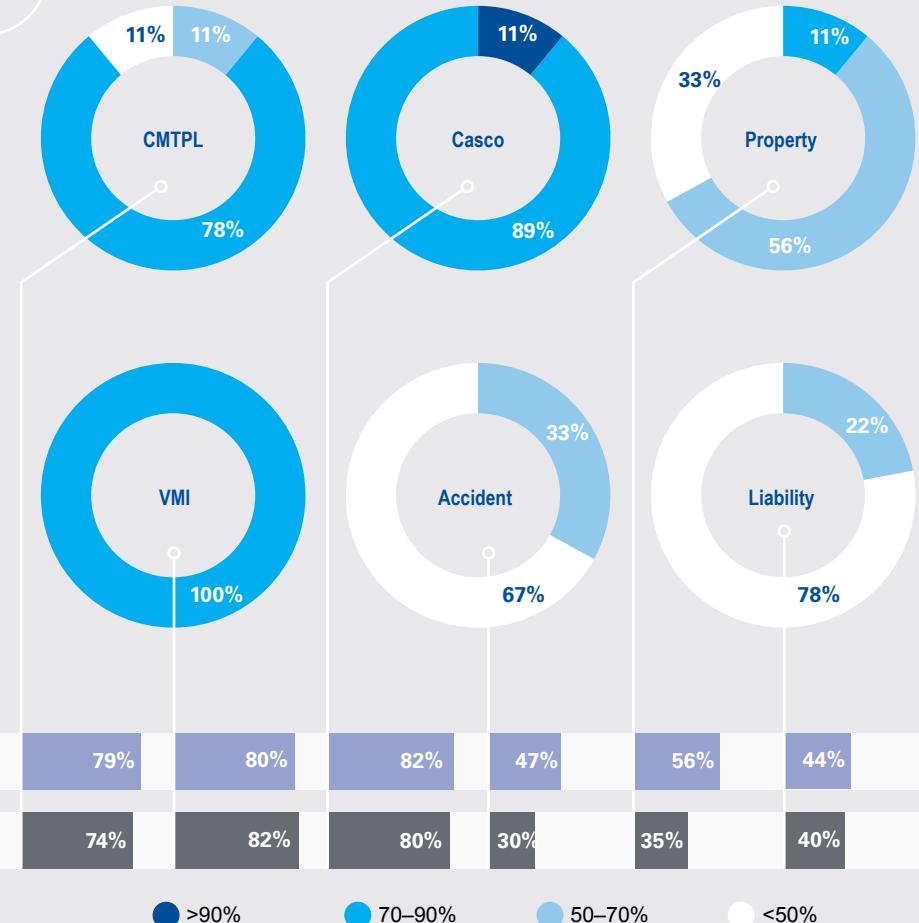
- raising SMEs' awareness about insurance products through partners (banks) and direct channels.
- insurance sales intensification in the SME sector.
- price diversification and improvement of insured risk assessment systems for SMEs.





Cost optimisation

Average expected loss ratios in 2014



Note: Percentages may not add up to 100 percent due to rounding.

Source: KPMG analysis.

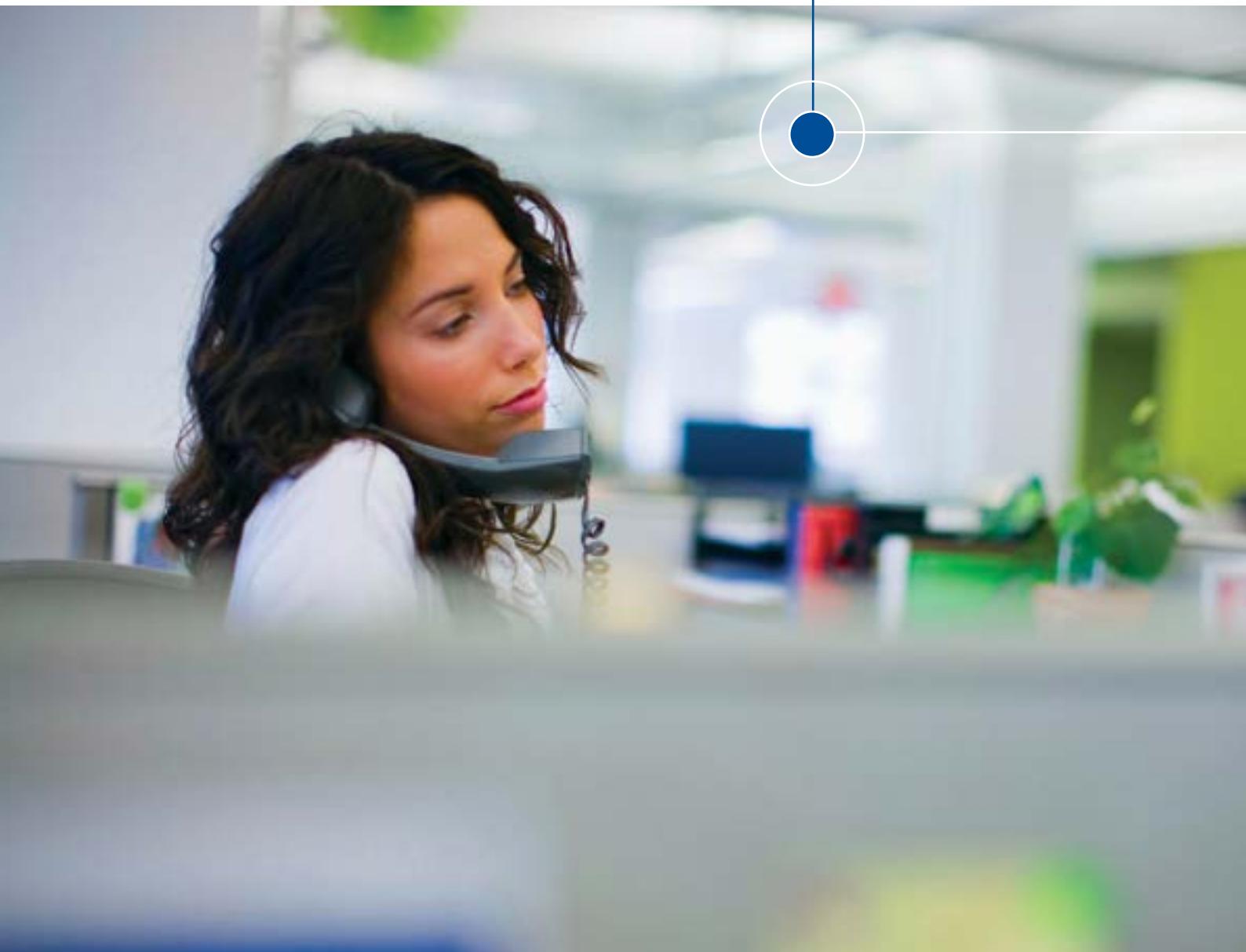
Actual loss ratio for Casco in 2013 has increased the loss ratio forecast for 2014: 11% of the respondents expect that the loss ratio in respect of Casco will exceed 90%, whereas in 2013 no one believed that this could happen.

CMTPL loss ratio forecast has been significantly raised. In 2013 43% of the respondents anticipated a loss ratio of less than 70%, however, in 2014 CMTPL loss ratio is expected to reach 80%.

Property loss ratio forecast has become more conservative: 89% of the respondents expect that loss ratio will exceed 50%, whereas in 2013 71% of the respondents believed that it would stay below 50%.

At the same time, insurance executives are more positive about the loss ratio for VMI. All the respondents believe that VMI loss ratio will stay somewhere between 70% and 90% in 2014. However in 2013 almost a third of the respondents anticipated that it would exceed 90%.

Casco, CMTPL and VMI continue to be the least profitable lines of business according to respondents' expectations.

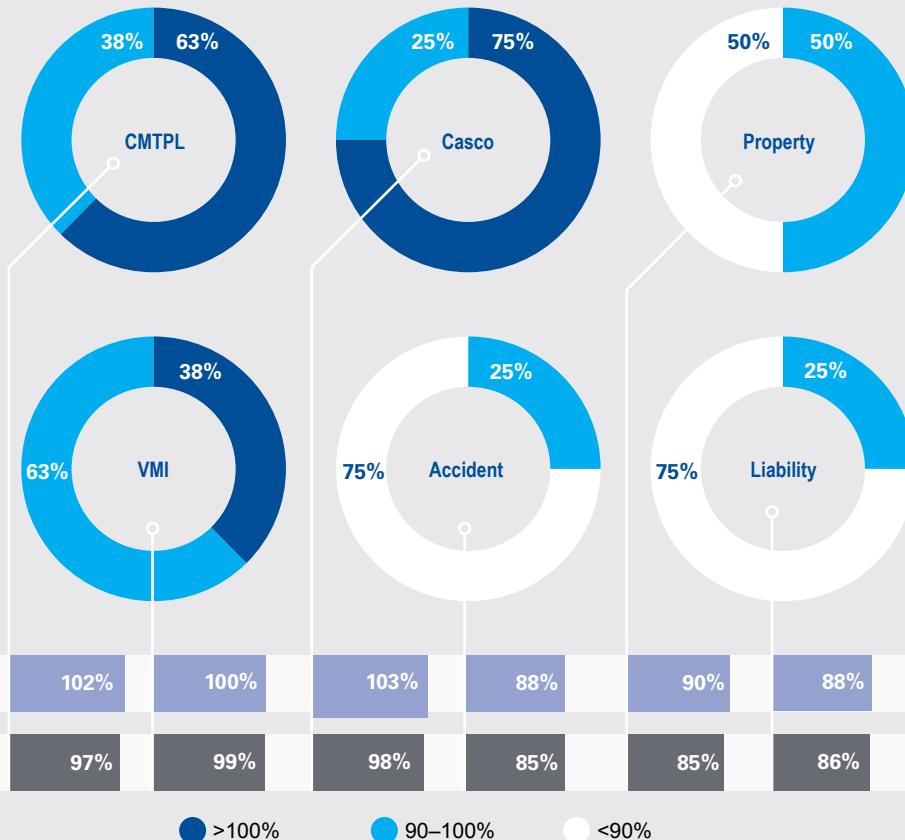


According to the respondents in 2014, the average expected VMI combined loss ratio will remain at the same level as in 2013. However, more than a half of the respondents predict that the combined loss ratio will not exceed 100%, whereas last year 57% of the respondents believed that it would be higher than 100%.

A significant decrease in motor insurance profitability is mostly attributed to the expansion of the Consumer Protection Law on the insurance industry. Insurers are bearing the burden of both increased legitimate claims and heavy court charges.

The attractiveness of property insurance will decrease due to expected significant drop in demand that would lead to a reduction of average market rates in this sector. Finally, 50% of the respondents assume that the combined loss ratio will exceed 90% in 2014.

Average expected combined loss ratios in 2014



Note: Percentages may not add up to 100 percent due to rounding.

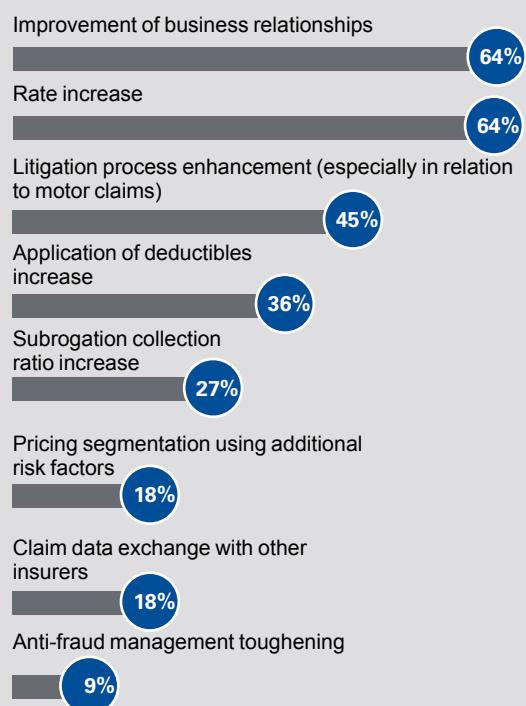
Source: KPMG analysis.

Maintenance costs will be reduced by optimising the organisational structure and centralising the main administrative functions, moreover, the implementation of new operational models would lead to a lower future administrative costs.

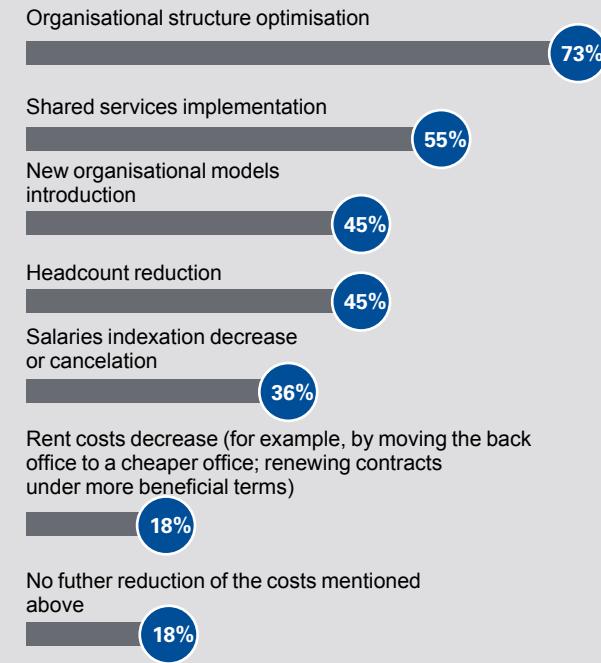
The respondents cite improving relationships with partners and increasing tariffs in respect of loss-making groups of clients as the main measures for claims reduction.



Preferred methods for reduction of claims costs in 2014



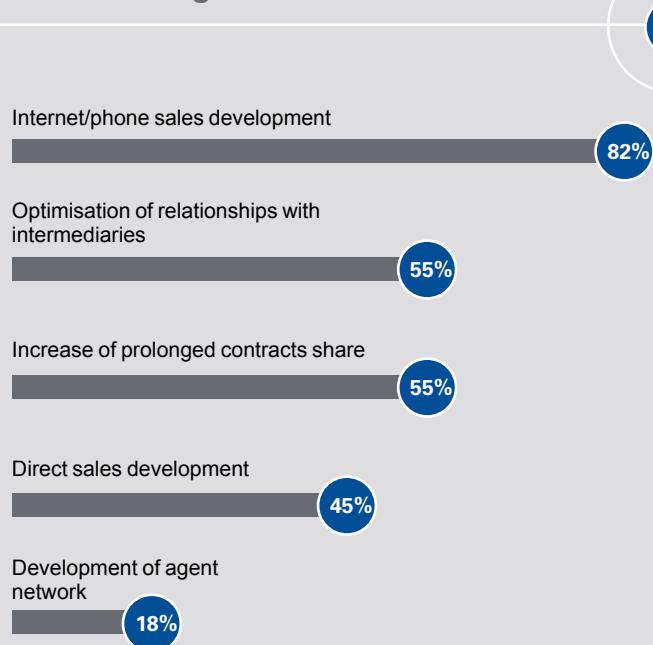
Preferred methods for administrative costs cutting in 2014



Source: KPMG analysis.

82% of the respondents are going to implement on-line sales of insurance policies, which would enable them to reduce acquisition costs significantly. As mentioned above, the bill that regulates on-line sales was approved in the third reading in May 2014 and was submitted for review to the Council of the Federation.

Preferred methods for acquisition costs cutting in 2014



Source: KPMG analysis.



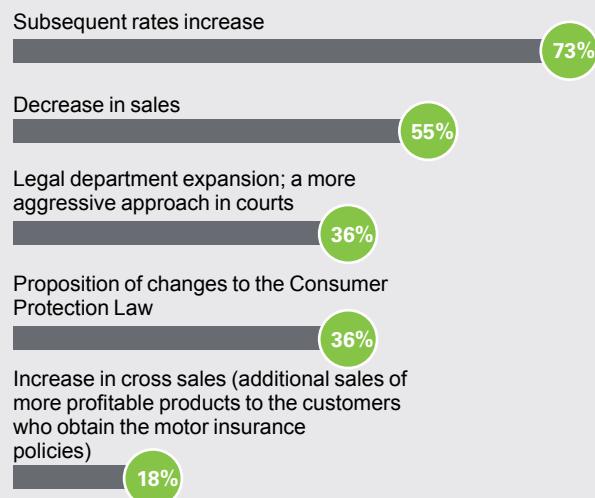


Motor insurance trends

The main factors driving the growth of motor insurance loss ratio are the following:

- **Government pricing regulation;**
- **Increase in fraud levels coupled with a lack of competence in identifying fraud;**
- **Expansion of the Consumer Protection Law on the insurance industry.**

Preferred methods for reduction of loss ratios in motor insurance due to the Consumer Protection Law expansion



Source: KPMG analysis.

The ambiguity caused by the expected increase in limits and rates has a negative impact on the CMTPL market. Insurance executives are going to take the steps required to compensate the expected increase in motor insurance loss ratios. 73% of the respondents will revise their Casco rates and consider including court charges in the basic rate.

Market participants will have to adopt more cautious approaches when selecting clients (and also regions): 55% of the respondents are going to reduce or limit sales in loss-making regions. 36% of the respondents plan to strengthen their positions in the courts.

The majority of insurance companies support a review of CMTPL tariff methodology. 45% of the respondents propose to set an unregulated market rate, while 30% of the respondents anticipate the introduction of a tariff corridor that would regulate the minimum basic rate and unlimited extended rate, allowing additional liability coverage. Another 30% of the respondents advocate an increase in CMTPL rates in correspondence with the average market loss ratio growth.

The increase in CMTPL limits will inevitably increase rates. However, more than a half of the respondents predict that the rates increase will reach less than 30% despite a three-fold increase in limits.

Preferred approaches to CMTPL pricing

No tariff regulation

45%

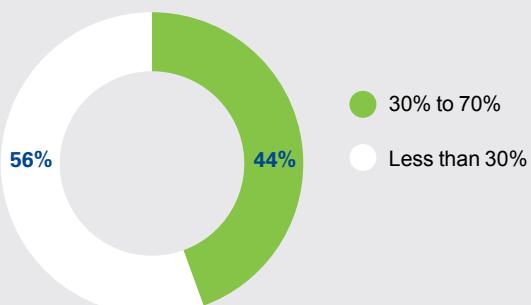
Tariff corridor introduction

30%

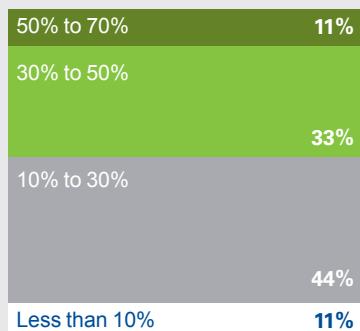
Increase in rates following loss ratio change

30%

Expected CMTPL tariff increase due to CMTPL limits increase



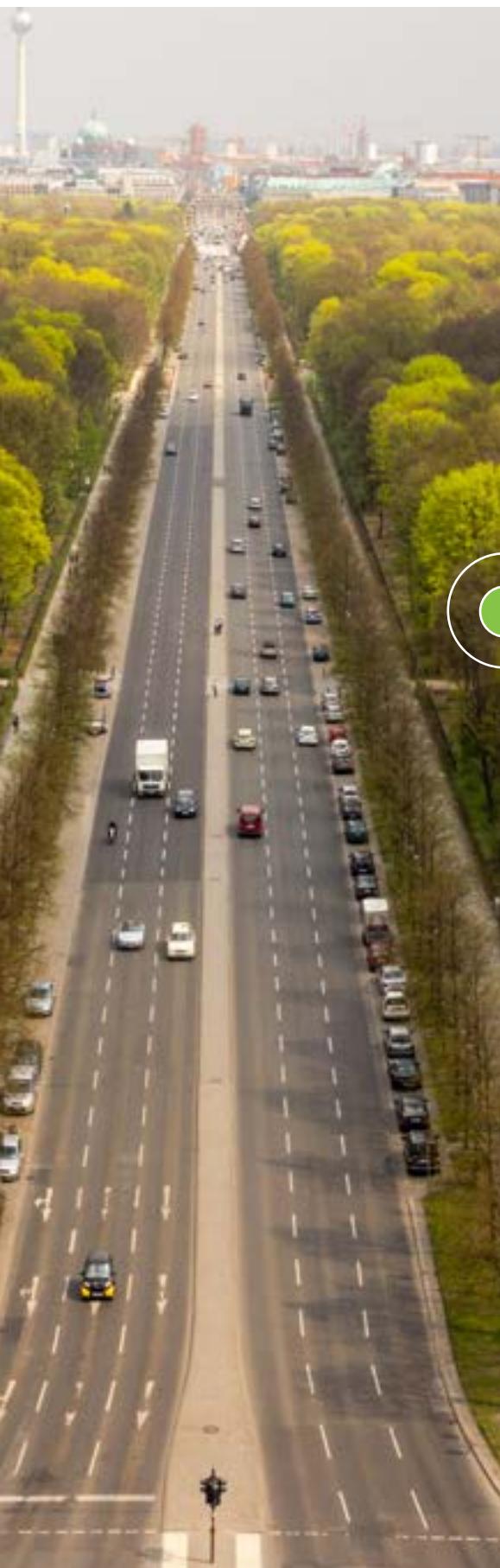
The share of fraud claims out of those settled under the Consumer Protections Law



Expected share of fraud claims

29%

Source: KPMG analysis.



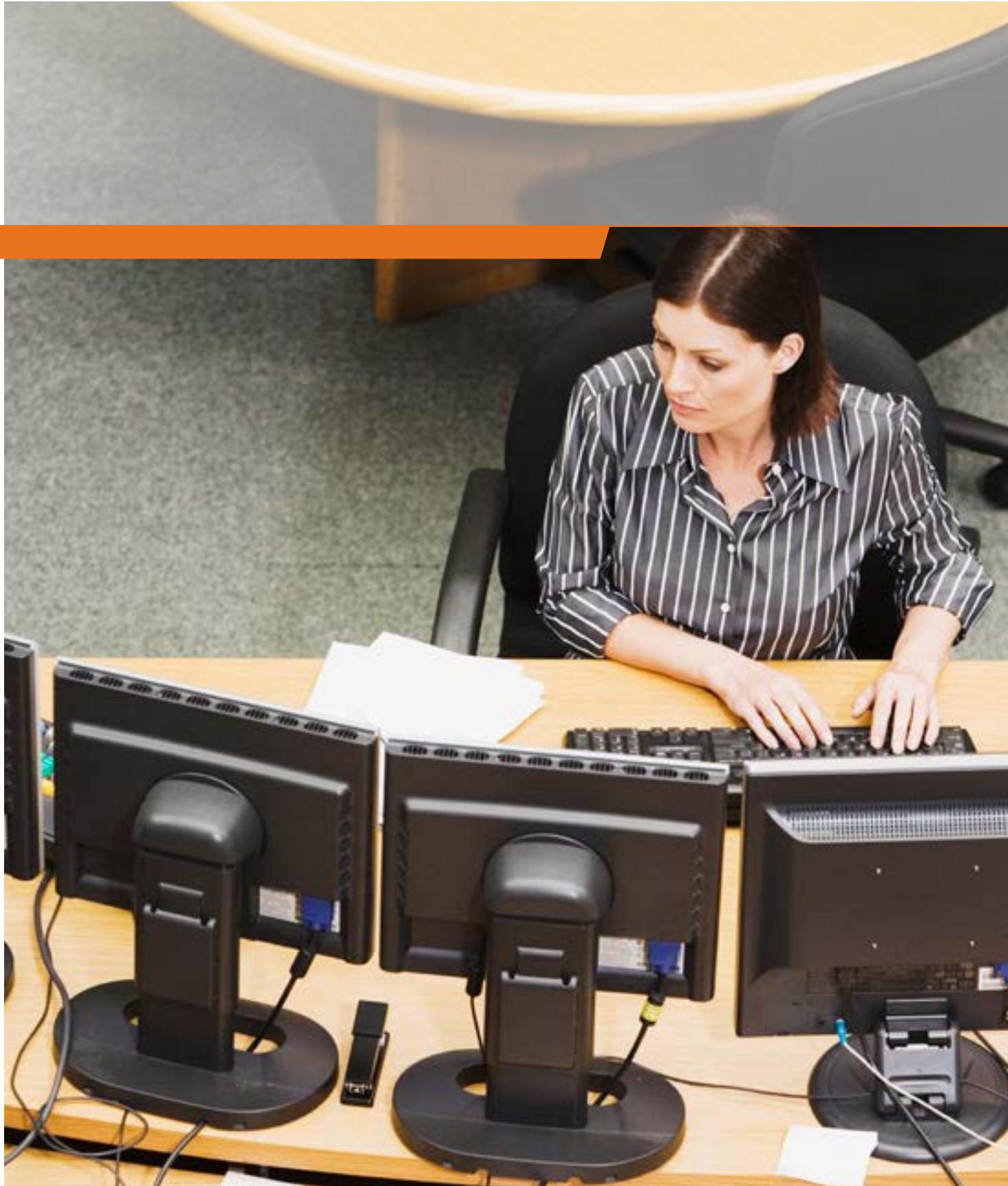
Many insurance companies attribute the sharp increase in motor insurance loss ratio to both government tariff regulation policy and steep rise of the fraudulent claims.

The growth of fraudulent claims among those settled under the Consumer Protection Law is a current trend in 2014 and is mostly attributed to the worsening of the macroeconomic situation in the country. 44% of the insurance executives believe that out of all the claims settled under the Consumer Protection Law by their insurance companies 10%–30% are fraud-related. A third of the respondents state that fraudulent claims accounts for 30–50%. The average expected share of fraud claims is 29% in 2014.



Along with the internal anti-fraud measures, such as the development of internal security services, insurance companies expect an external intervention from the “megaregulator” aimed at fraud reduction. These measures could include introduction of an insurance fraudsters register and toughening of punishments for fraudsters.

There are extensive complications in the establishment of a self-regulating market mechanism for fraud identification. Therefore there is a demand for establishment of such mechanism by the regulator, which has a more effective leverage on the market.





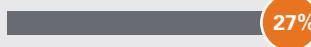
Market regulation

Consequences of introduction of the new “megaregulator” under the Central Bank

The increase of regulatory pressure though beneficial for the market



Too early to say



Nothing has changed

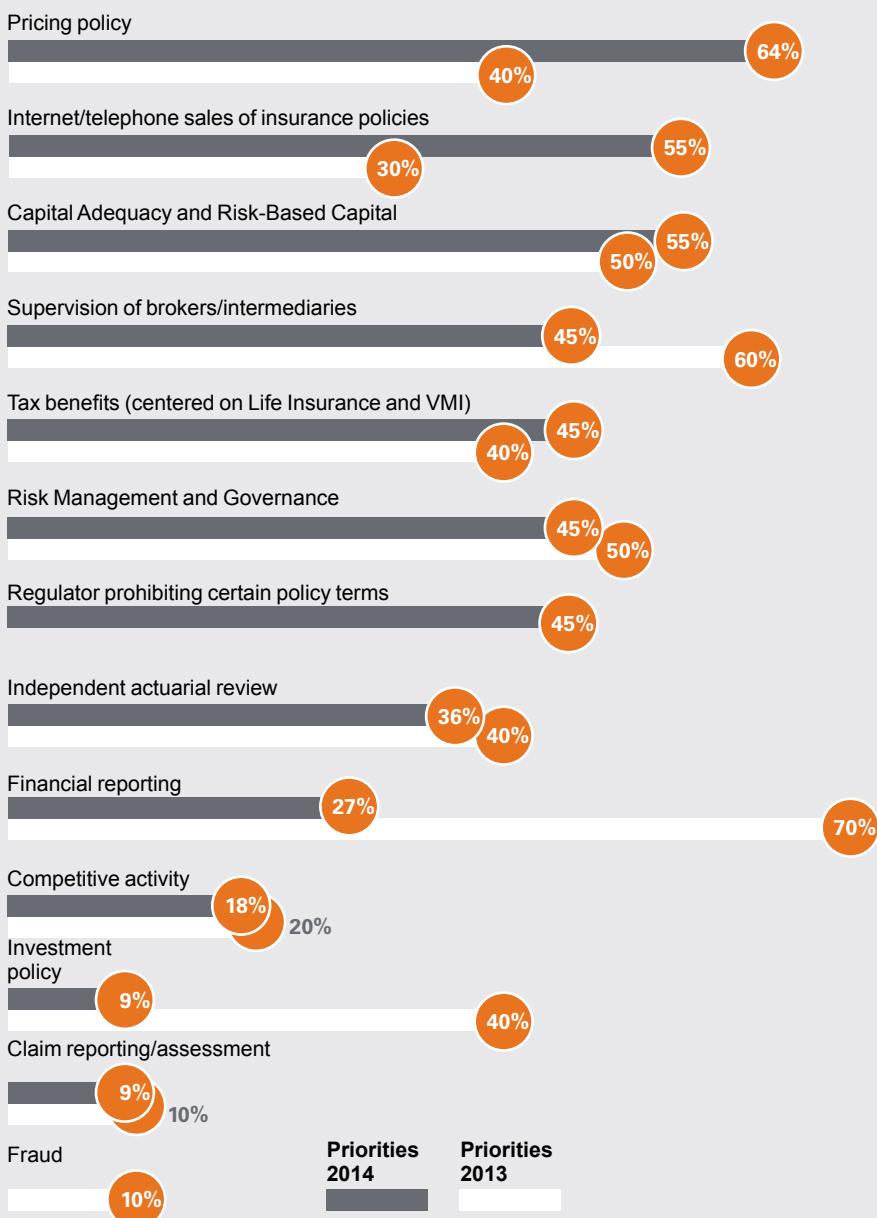


Source: KPMG analysis.

On the whole, insurers are positive about the establishment of the united financial “megaregulator” based on the Central Bank of Russia.

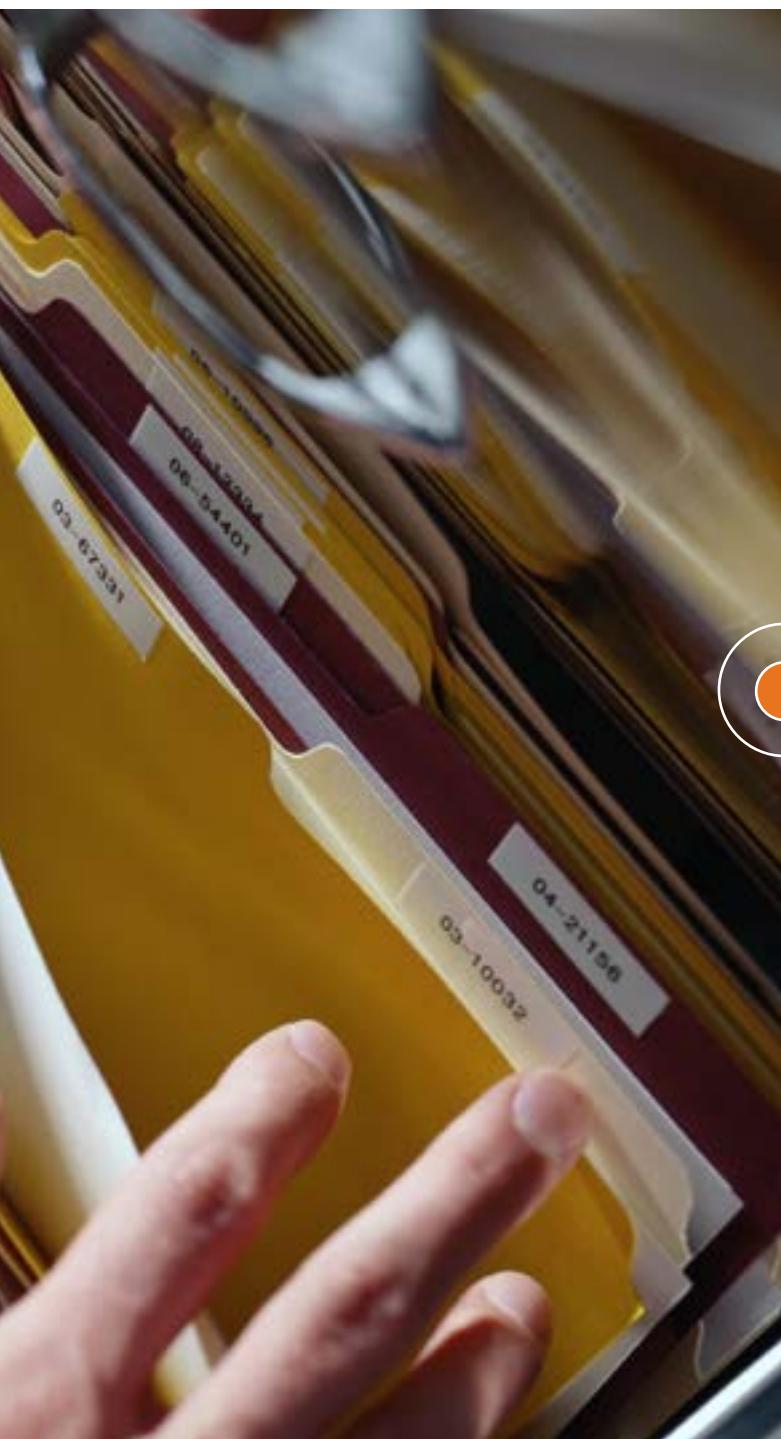
64% of the respondents believe that the market has already benefited from the supervisory centralization. Moreover, experts are looking forward to observe positive trends in the market regulation over the next few years – this will definitely compensate for the transitional period strain on insurers.

Areas required progressive changes in the regulation



Source: KPMG analysis.

The focus of the areas needing more robust regulatory oversight has shifted away from financial reporting towards ensuring business sustainability (capital adequacy, rates and sales limitation, tax benefits).



Pricing policies and capital adequacy are now among the most important factors for state control, as they directly influence the profitability of insurance business. The bill that regulates on-line sales of insurance policies is expected to be enacted in 2014, insurers consider this area as one of the preferred for closer supervisory control in the short term perspective.

At the same time insurers are less concerned about financial reporting and the investment policies, these two are less relevant due to the negative macroeconomic trends.

Possible changes that could have a positive influence on the capital requirement level

Transaction to foreign practices
(for example, Solvency II)

55%

Change in asset allocation rules

27%

Change in the solvency margin calculation
(Federal Law No. 90n)

9%

Source: KPMG analysis.

At the same time, most of the respondents also think that the Russian insurance market needs to adopt risk-based methodologies of solvency capital estimation which are used on the most developed markets (for example, Solvency II) adapting them to Russian realities.

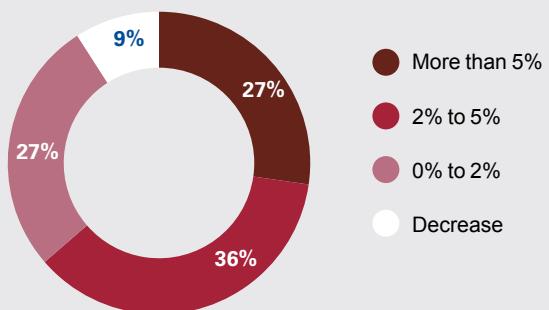
Most of the respondents (70%) believe that the capital adequacy requirements in Russia are acceptable.





M & A activity

Increase in market share of Top 10 in 2014



Expected increase in market share of Top 10

3%

Note: Percentages may not add up to 100 percent due to rounding.

Source: KPMG analysis.

The decrease in market growth rates, unfavourable economic conditions and the fall in profitability are the factors contributing to an increase in market concentration level. The consolidation is expected in all market segments.



Likely M&A activity in 2014–2015

Sale of one or more large Russian insurance companies

55%

M&A activity among Russian companies

55%

Licence revocation from large insurance companies

55%

Foreign companies leaving the market

45%

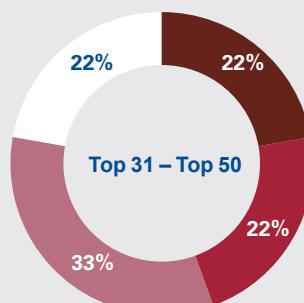
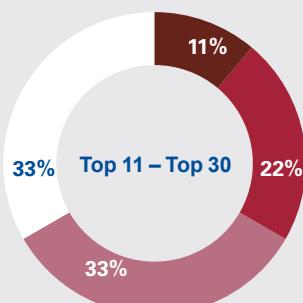
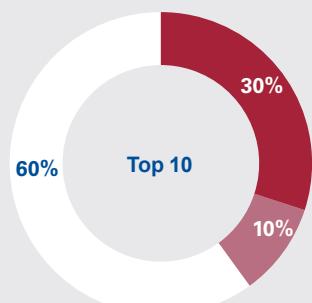
Source: KPMG analysis.

91% of the respondents expect an increase in the aggregate share of Top 10 insurance companies. The consolidation is attributed to expected redistribution of forces among the market leaders. More than a half of the CEOs expect a merger among the leading players, an acquisition of one of Top 10 companies or a direct sale of one of the market leaders in 2014.

Half of the respondents believe that the license of one of the market leaders could be revoked. Moreover, insurers believe that there are companies on the verge of bankruptcy in each segment of the insurance market. Taking in consideration toughening insurance supervision, it can be expected that licenses will be revoked in all market segments in the coming year.

The percentage of insurance companies which are close to bankruptcy/ licence revocation per segment

- More than 40%
- 20%–40%
- 10%–20%
- Less than 10%

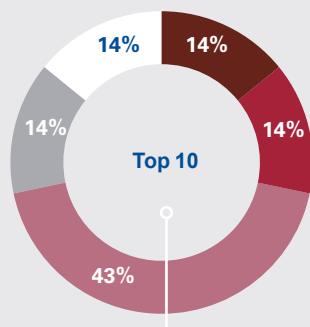


Note: Percentages may not add up to 100 percent due to rounding.

Source: KPMG analysis.

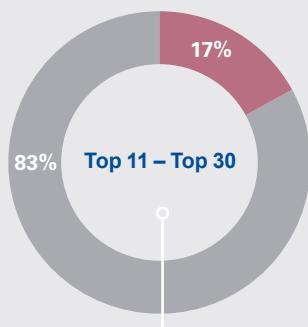
Assessment of the multipliers per market segment in 2014

- >2
- 1.5–2
- 1–1.5
- 0.75–1
- 0–0.75

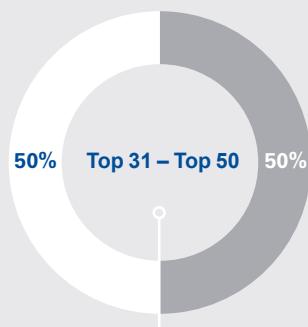


Average expected multiplier

1.3



0.9

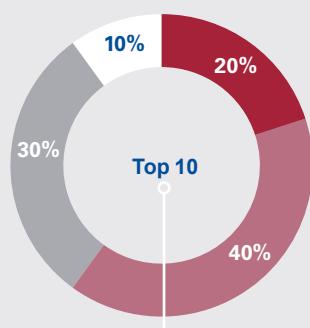


0.6

Note: Percentages may not add up to 100 percent due to rounding.

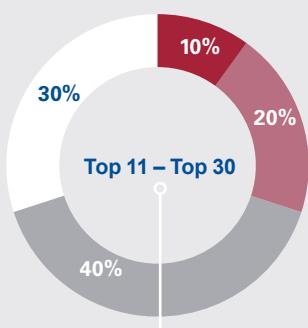
Assessment of the multipliers per market segment in 2013

- >2
- 1.5–2
- 1–1.5
- 0.75–1
- 0–0.75

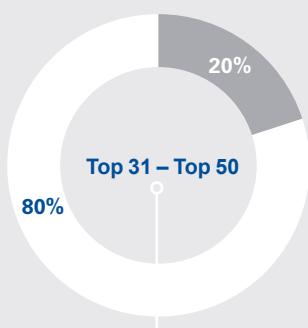


Average expected multiplier

1.2



0.9



0.5

Source: KPMG analysis.

The average assessments of multiples showed the same numbers as in the previous year. Thus, market participants maintain a conservative view on the values in light of the regulatory and macroeconomic changes underway in Russia.

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