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"Wing Walking" in Russia

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When big problems are encountered, nimble resolutions are sometimes attributed to people of undeniable talent—to those "wing walkers" who are able, in effect, to repair aircraft engines while in flight. Russian insurance executives have become especially skilled in the management of complex organizations in an uncertain economic and political environment, and they could be considered the "wing walkers" of the Russian Federation.

Russia has been undergoing an energetic and highly publicized transition to democracy and a functioning market economy since former President Mikhail Gorbachev launched "glasnost" (openness) and "perestroika" (restructuring) in the 1980s.

President Boris Yeltsin's government has continued the reform process although the results have been uneven and somewhat slower than expected. Many of the reports about Russia in the past decade have concentrated on the fallout associated with economic, political and social change and the evening news is still festooned with the difficulties encountered in this country's efforts to embrace the freedoms that we accept as routine.

Traditional news coverage often overlooks real progress, especially in the growth of the insurance sector in Russia. Insurance development began during the 1991-1993 time frame and Russia has since moved forward with enviable speed to do what took the United States most of this century to accomplish.

During the Soviet era, insurance was a state monopoly. Domestic programs were provided by the Gosstrakh Insurance Company while international coverages were the domain of Ingosstrakh. There had been little need for insurance in Soviet times and the state, in effect, had become an all-embracing insurance organization through the implementation of its political and social philosophy.

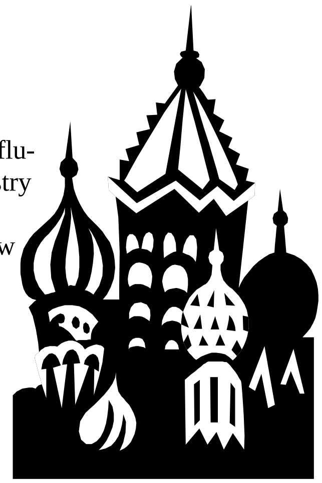
The Soviet state, with its comprehensive social programs, granted various insurance-type benefits to its citizens (pensions, disability insurance, health care and survivor benefits) and there was little need for individually purchased policies. Small life insurance endowment policies were traditionally purchased for young children while automobile and property ownership was rare.

After the 1991 coup d'état attempt and the dismemberment of the U.S.S.R. that followed, and with Boris Yeltsin's ascendancy as president, the Russian Federation started to change dramatically as it struggled to become more like a market economy. The state began to reduce government-supported insurance programs and, at the same time, the privatization of the economy and new laws allowing private property ownership created a need for personal insurance.

The first Insurance Code for Russia was approved in January 1993 and capital requirements were such that more than 2500 companies were licensed to operate. Many companies were organized with an insufficient financial base and with little practical knowledge of the business of insurance while a smaller number of insurers were more focused on specific markets and product opportunities. Early growth occurred in several life insurance variants which became popular because they reduced tax liabilities on payroll compensation and in commercial lines and property insurance.

During the period from 1993 to 1997, the inflation rate reached 840% per year before falling to 11%. As a result, the more successful Russian insurance companies became operationally proficient within an unpredictable economic environment, with its volatile currency fluctuations, and in providing products and services which had to be quickly adapted to the marketplace. In many cases, Russian insurance companies received premium in older, more valuable rubles while benefits were paid in newer, inflated rubles.

During the mid-1990's, the All Russian Insurance Association became the most influential industry trade group and Moscow State University developed into the predominant insurance education center for the country while forming links with the European Union (E.U.). The Insurance Subcommittee in the Duma (Russian Parliament) began consideration of modifications to the Insurance Code in order to comply with both E.U. and the World Trade Organization (W.T.O.) standards for insurance regulation and an open market.



Premium production in the Russian Federation grew quickly during the 1990s, growing from $1.35 billion in 1993 to a total of $5.91 billion in 1997. Despite political and economic problems, domestic companies began to grow and offered a range of products. The companies began to advertise and to educate potential customers about the general benefits of insurance and risk management.

While insurance penetration in Russian (insurance premium as a percentage of gross national product) was 0.77% in 1993, it had grown to 1.32% in 1997, but it was still below Poland, the Czech Republic, Hungary and Western Europe. Russian companies, however, recognized that they had discovered a motherlode and became concerned about international competitors in their home territory as some of the larger international insurance groups began to take notice of the potential market beginning to emerge in Russia.

Foreign interest in the Russian insurance industry has continued to attract attention among domestic insurers who look to the Insurance Code as an interim protective screen. Some companies are concerned that their industry could be exposed to an overwhelming application

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of capital and technology that would smother domestic development. Modified in 1998 and undergoing an intensive review in the Russian Parliament, the Code currently prohibits foreign companies from owning more than 49% of a Russian insurance company.

Over the past three years, an open debate has continued within the Russian insurance industry about W.T.O. and E.U. compliance and continuing protection, of some sort, for the domestic companies relative to the perceived capital strength and the capital availability of (primarily) foreign investors. The larger companies are less concerned and view foreign investment in positive terms.

Recently proposed Code changes provide for ownership in excess of 49% by foreign investors, but do require certain security deposits with the Central Bank and do not allow for a 49%+ foreign-owned insurance company to engage in life insurance, obligatory insurance or property insurance for State owned enterprises. Importantly, the proposed Code changes do not place restrictions on Russian insurance companies with less than 49% foreign ownership. The Duma has not set a specific date for further review of the Code amendments, but plans to consider them before the end of 1999.

One of the main features of the Code proposals is a quota standard by which foreign capital will be limited to somewhere between 12% and 20% of the authorized capital of all insurance companies operating in Russia. The quota, in effect, would place a franchise value on most Russian companies in that foreign investor groups, concluding partnership agreements before the Code is modified, will gain a competitive and absolute advantage over those choosing to delay entry until some more convenient point in the future.

The principal impact of the revised Insurance Code would be (1) to encourage investment before the quota is reached, (2) to increase the implicit value of equity stakes in Russian insurance companies as the quota limits are reached, (3) to increase the competitive advantage that would inure to early investors in the Russian insurance marketplace, (4) to allow Russian insurance companies, with less than a 49% equity stake held by foreign investors, not to be subject to increased requirements or additional limitations and (5) to require foreign insurers, attempting to operate independently in Russia, to comply with the additional financial standards.

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This is an interesting period in the young life of the Russian insurance industry. This is not to say that effective business combinations cannot be achieved and become extremely successful. On the contrary, Russian companies have the market knowledge and are aware of customer sensitivities that will not soon be understood by Western organizations. Western groups have the capital for expansion and the capacity to conduct insurance technology transfer necessary to propel the Russian industry into the next century at an accelerating rate. The challenge will be to match the two into effective and enduring business combinations.

The Russian Federation and its people have experienced change of a variety and intensity that would be a fatal blow to most nations. Despite troubling times, Russian consumers continue to acquire private property and they are, in turn, purchasing a variety of insurance products.

Domestic insurers have been tested, in a variety of ways, over the past ten years, and Russia, regardless of its political composition, has no alternative to privately-owned insurance companies for the delivery and administration of social insurance programs, state health care benefits, mandatory insurance coverage and certain financial services.

The Russian insurance industry is responding rapidly to the unwelcome economic and financial burdens visited on it in August 1998. Despite this recent crisis, the insurance industry in the Russian Federation remains fundamental to social and economic progress.

Domestic insurance companies are set on becoming more effective. The more capable domestic companies have been acquiring books-of-business and orphan policyholders while, at the same time, developing new policies which emphasize competitive value, safety and security. They are concentrating on customer service and business retention. Learning from the recent default and devaluation, they are adapting more conservative investment portfolio management. Companies have started to control acquisition costs and operating expenses and to expand distribution.

Geography has made it difficult for insurance carriers to expand beyond the urban centers of European Russia. The Russian Federation with more than 147 million people living across a territory of 6.5 million square miles is wrapped into 11 time zones.

Russia's immense territory creates challenges for communications, transportation and management control that can be daunting, but many Moscow-based companies now envision an opportunity to acquire regional companies and sales networks and then expand into the Russian provinces where the opportunities are greater and operating costs and market penetration are lower.

Distribution can now be expanded at a marginal cost allowing companies to extend their marketing territories. Companies are reducing acquisition costs through new techniques and as group and affinity marketing, direct marketing and sales points become widespread. Sales points are a particularly effective distribution tool which brings home office convenience to the marketplace. They are also devoting much closer attention to expense control, data automation and professional education and development.

Russian insurers now consider the customer to be one of their most important assets. Business retention programs are receiving more emphasis while customer convenience and customer service are moving to become a significant component for successful company marketing programs. Cross-selling to existing clients will reduce acquisition costs and encourage business persistency. Follow-on insurance and investment services and repeat purchases are being incorporated into the marketing lexicon for Russian insurers.

Russian insurers are carefully responding to the challenges that often flow from economic uncertainty in their country. Insurance penetration is gradually increasing as consumers seek to protect assets, create pension supplements or plan for wealth transfer and as Russian businesses become more committed to risk management, either to reduce loss exposure or because of investor requirements.

Russian banks have suffered severe financial losses since the recent economic crisis. More importantly, banks and the banking system have lost consumer confidence as the population struggled to recover their deposits from commercial banks and transfer them to the State Savings Bank. There are continuing indications that the Russian consumer has not lost confidence in insurance companies. They recognize that insurers were not responsible for the crisis and the insurance industry is now in a more prominent position.

The Russian insurance industry is rapidly coming into its own and is the leading component in the emerging financial services sector. Insurance offerings range from traditional life and disability policies, annuities and tax-advantaged products to property, liability and health care coverage and to more complex commercial packages, space vehicle and satellite risks and reinsurance.

While approximately 1400 Russian insurance companies remain licensed, that number will probably decrease to no more than 500 to 600 companies in the next 18 months as the less competitive companies are acquired and as weaker insurers fail to meet recently enacted capital requirements. About 100 of the surviving companies will generate more than two-thirds of the premium volume in Russia and the top 25 companies will effectively control the marketplace.

Russia is not a weak insurance market—it is only an underrated one. The While substantial problems have been experienced, and some may continue in the near term, some observers manage, quite incorrectly, to attach the same degree of economic and financial malaise to the insurance sector as elsewhere in the Russian Federation.

In the last five years insurance premium has grown at a faster rate than gross national product. While it is certain that inflation and other economic factors influence insurance activity, we should

Development Phases in Russian Insurance

Phase One	1993-1994	Industry sector building process
Phase Two	1995-1997	Limited investment by the West
Phase Three	1998-2000	Market potential recognized
Phase Four	2000-2001	Open market and faster growth
Phase Five	2002+	Significant Western participation

Russian Federation produced total 1997 premium of almost $6.0 billion, of which about $1.5 billion was life insurance and annuity premium. It can be estimated that about the same level of premium was achieved in 1998, considering the effect of the August 1998 financial crisis and its lingering impact. Internal factors alone, without consideration for economic improvement in Russia, should produce an annual growth rate within the insurance sector approaching more than 15% to 20% over the next five years.

China, on the other hand, is often considered to be a lucrative target for expansion and has become a popular venue for insurance development. With a population of more than 1.2 billion people, China produced $15 billion in premium in 1998—yet with only 12% of China's population, Russia produced more than 39% of China's premium. Per capita insurance premium has reached at least $41.00 in Russia while China registered $12.50 per person, indicating Russia is more advanced than generally appreciated.

Russia's difficulties with economic transition are often misread in the West.

recognize that the business of insurance in Russia has developed its own momentum and has sustained this outstanding record of growth despite the turbulence we have seen.

The Russian insurance sector has grown more rapidly than other industries. With a start-up phase that became entangled in an attempted coup and the collapse of communism, insurance development required a consumer education process that paralleled marketing and sales activities. To compound this new market experience, Russian insurance companies were forced to live with and to survive during a period of hyper-inflation. While insurers strengthen their financial condition to accommodate changing market parameters, they have entered the next development.

Russia's growth, to date, has been generated primarily from internal resources and with limited access to public markets or foreign investment. Expansion capital is required to improve

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- Professional Development - Guidelines for Advisors
- Professional Development - Letter of Commitment
- Professional Development - Frequently Asked Questions (FAQ)

A list of the SOA seminars that have been approved as eligible for PD credit is located on the SOA Website. For example, you can determine which sessions of the 1999 SOA meetings (May 24-25 in Atlanta, June 16-18 in Seattle and October 18-20 in San Francisco), and the CIA meeting (June 17-18), are eligible for PD credit.

Questions on the PD programs or comments regarding any of the PD documents may be directed to the Professional Development Committee at *pdcomments @soa.org*. International students residing in Asia may contact Patrick Cichy, the Coordinator of Asian Services in Hong Kong, e-mail address: *patrickcichy@ compuserve.com*.

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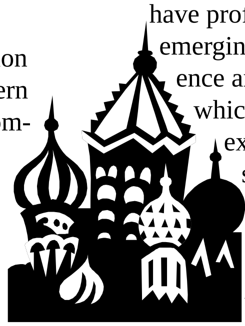
the financial strength and competitive position of Russian insurance companies. Additional capital, along with contemporary insurance technique and technology, would benefit both Russian insurance companies and the marketplace. This capital would provide for the acquisition or development of an even more modern range of products and services to accommodate the requirements of a sophisticated population and business environment.

Additional capital investment would allow select and qualified insurers to exploit and service the many opportunities within the Russian Federation, to conduct insurance education and publicity programs as well as to capture market share, reduce operating expenses on a per-policy basis and to sell and cross-sell more products to a larger customer base.

The better Russian insurance companies have already seized a commanding market position and enjoy a respected identity and image. These companies have professional management, emerging market operating experience and positive earnings, all of which would be extraordinarily expensive for a Western strategic investor to duplicate.



The Russian insurance industry has been visited with a variety of subtle though substantial opportunities while, at the same time, it is little understood and often quite routinely ignored by more mature economies. Russian insurance professionals, the "wing walkers," have been tested in more ways than we can imagine and they have quickly become a national treasure.

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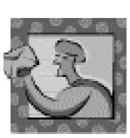
Cast Your Ballots in the Section Elections

Ballots for the Section elections will be mailed the first week in July. Take an active role in the election process. Review the list of candidates and their biographies to determine whom you would like to represent you.



Ballots must arrive in the SOA office no later than August 6. If you are a Section member and do not receive the election mailing by July 23, contact Jeanette Selin at the SOA office: phone: (847) 706-3533; fax: (847) 706-3599; or by e-mail: *jselin@soa.org*.