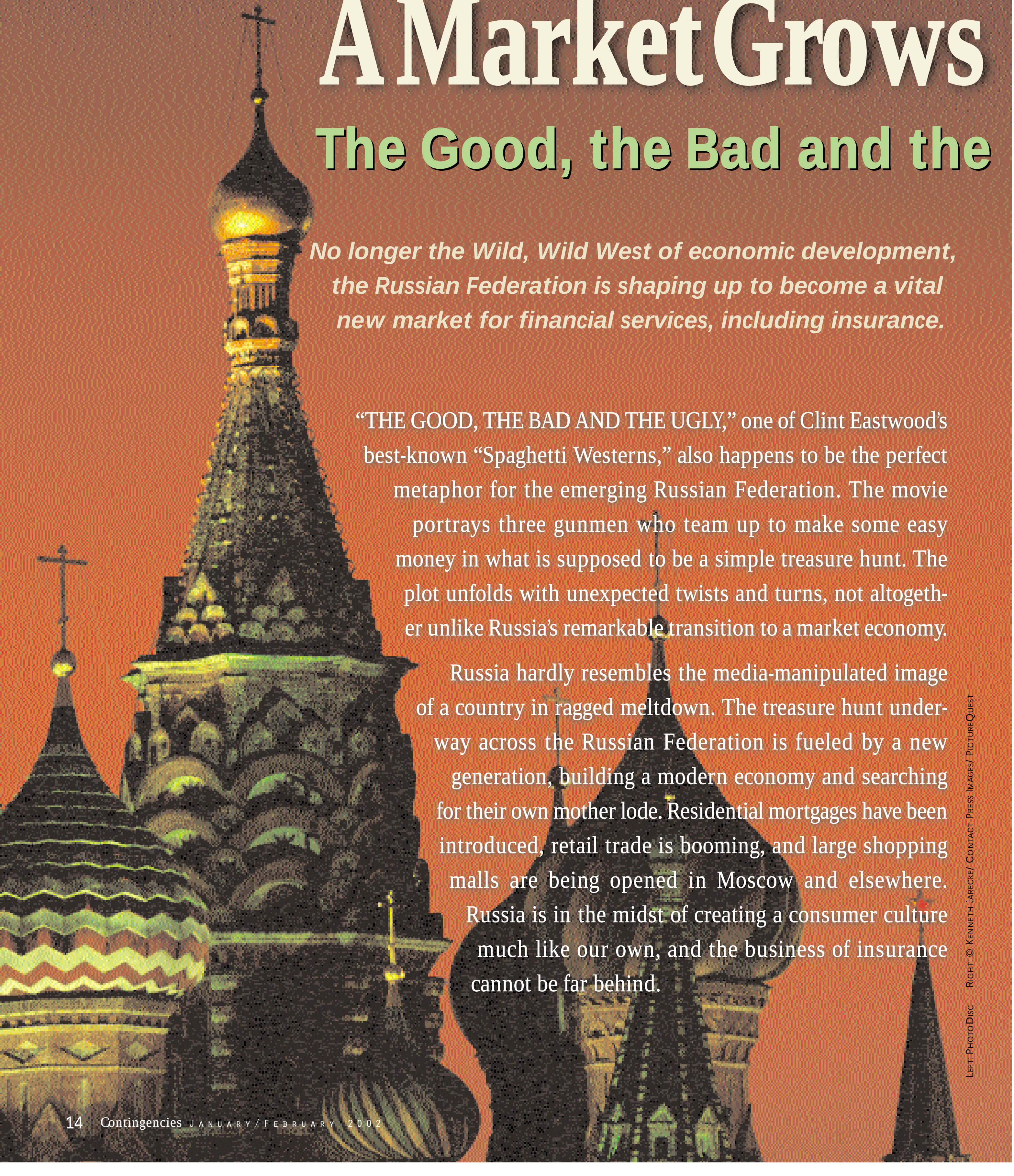
By Mark D. Mariska and Anton O. Ostrovskiy

A Market Grows

The Good, the Bad and the

No longer the Wild, Wild West of economic development, the Russian Federation is shaping up to become a vital new market for financial services, including insurance.



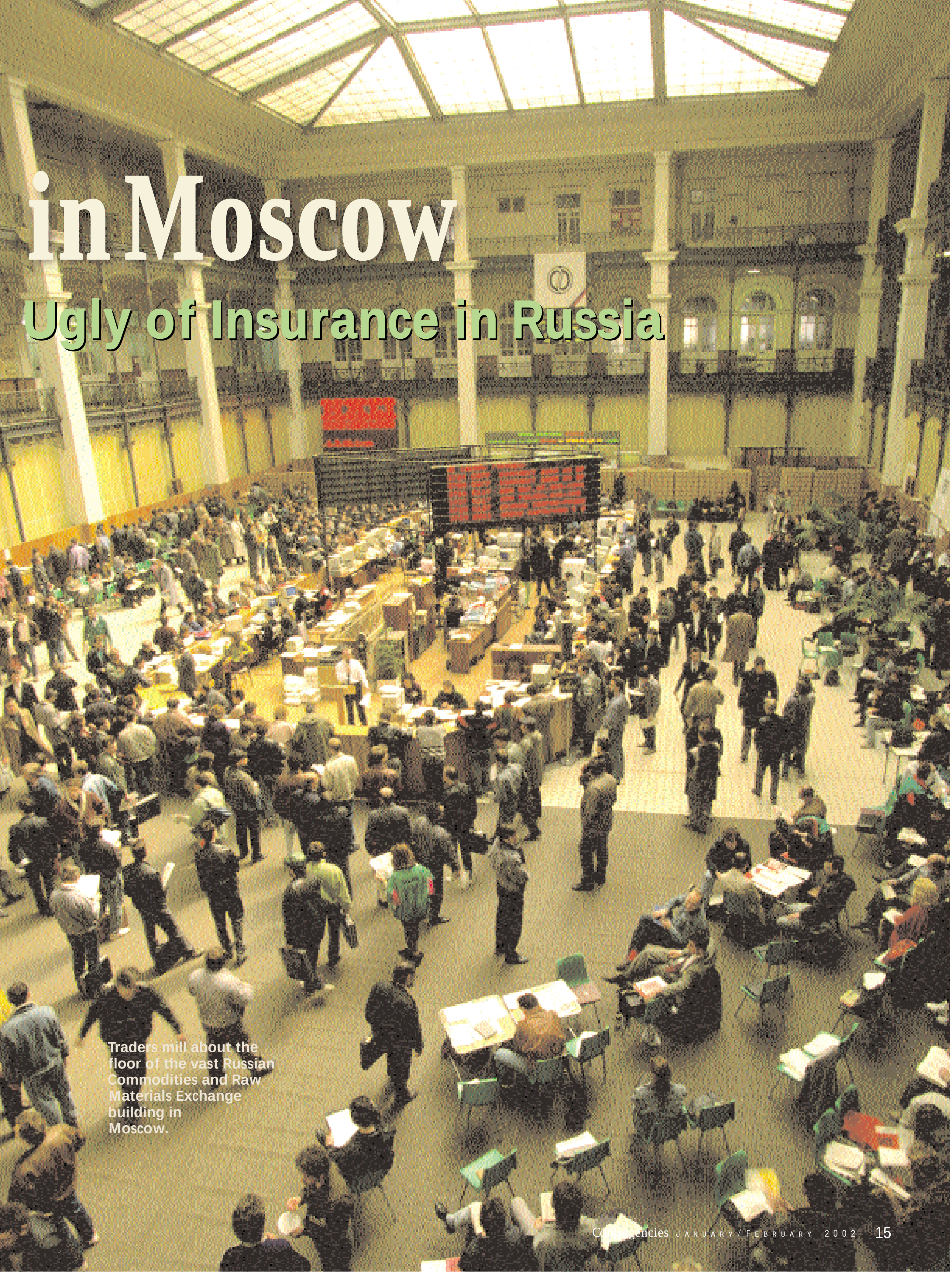
"THE GOOD, THE BAD AND THE UGLY," one of Clint Eastwood's best-known "Spaghetti Westerns," also happens to be the perfect metaphor for the emerging Russian Federation. The movie portrays three gunmen who team up to make some easy money in what is supposed to be a simple treasure hunt. The plot unfolds with unexpected twists and turns, not altogether unlike Russia's remarkable transition to a market economy.

Russia hardly resembles the media-manipulated image of a country in ragged meltdown. The treasure hunt underway across the Russian Federation is fueled by a new generation, building a modern economy and searching for their own mother lode. Residential mortgages have been introduced, retail trade is booming, and large shopping malls are being opened in Moscow and elsewhere. Russia is in the midst of creating a consumer culture much like our own, and the business of insurance cannot be far behind.

Left: PhotoDisc Right © Kenneth Jarecke/ Contact Press Images/ PictureQuest

in Moscow

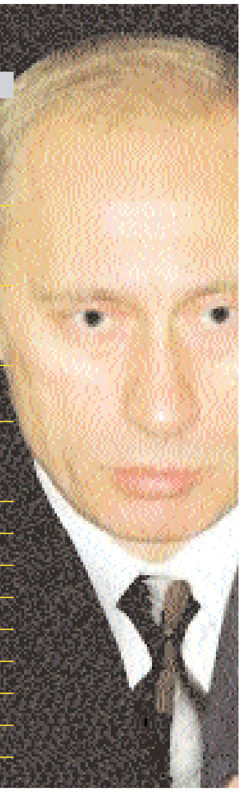
Ugly of Insurance in Russia



Traders mill about the floor of the vast Russian Commodities and Raw Materials Exchange building in Moscow.

The Russian Federation: 1997 vs. 2002

	1997	2002
President	**Boris Yeltsin** Ill and in coma followed by bouts of public inebriation	**Vladimir V. Putin** Flying a Sukhoi SU-30 fighter jet and practicing martial arts
Relationships	Uncertain “engagement” with U.S. after Cold War	Becoming U.S. ally and partner and possible member of NATO
Perception of Russia	Risky, emerging market with a “terrorist problem”	Comparable risk to U.S. domestic market now under terrorist threat
Parliament	Restoring Communist rule	Passing more liberal reforms
Oligarchs	Small group with increasing power and influence	Smaller group with decreasing power and influence
Corp. Governance	An oxymoron	Now becoming very popular
Taxes	Personal 30%, Corp. 35%	Personal 13%, Corp. 24%
Domestic Debt	$60.0 billion	$10.0 billion
CBR Reserves	$18.0 billion and vanishing	$40.0 billion and rising
GDP Growth	0.8%	4.0 to 5.0% (projected)
CPI	11.0%	15.0% to 17.0% (projected
Budget Balance	2.0% deficit	4.0% surplus (projected)
Insurance Premium	$3.0 billion	$11.0 billion (projected)



The Good

Standard & Poor's recently reported that as “foreign insurers succeed in opening the market, the potential rewards are great. The average Russian spent $25 on insurance in 1999, compared with $117 in Poland. In contrast to an EU average of $1,800, there's great potential for growth, with the Russian market potentially worth more than EURO200.0-billion (about $175.00-billion) if insurance spending levels reach those of Western Europe.”

Russia has changed for the better. These changes are evident in its convincing domestic performance and through more cooperative international relations. Russian support of America in the aftermath of the Sept. 11 terrorist attacks marked a “seismic sea change of historic proportions,” according to Secretary of State Colin Powell. Russia's cooperation with the anti-terror coalition would have been unthinkable in the past and bodes well for the future.

A comparison of the changes in Russia over the past five years is in order. Political direction and public spirit have improved, and the economy is growing stronger. The resilient Russian consumer is replacing the Soviet-style stereotype of the past.

Just about everything that has happened to the Russian economy since the August 1998 financial crisis has been constructive. Most analysts link economic growth to two factors: favorable market conditions for Russian export commodities, principally petroleum (although recent events have placed some doubt on petroleum pricing), and the ruble devaluation effect from the financial crisis.

It's important to recognize a third and equally significant factor: the qualitative change in management among the Russian business class. In the future it's this third factor, management, that will be decisive in the continuing renewal of Russia that should, one day, be referred to as the *Russian economic miracle.*

Beyond Red Directors

As an entrepreneurial atmosphere was encouraged and business germinated, Russia passed through two important stages. In the first stage, under Perestroika, and for a few years thereafter, very little changed in the management of Russian enterprises. With the collapse of the planned economy, those who remained in power were what are conventionally called *Red Directors* (basically the same people who were running large enterprises under socialism).

The management style of the *Red Directors* was complacent, uninspired, and driven by plan and not profit. Then they found themselves thrust into a new environment in the early 1990s, with its radical economic and political realities. The challenges they had to face required creativity and the ability to fight effectively for the survival of archaic production facilities. The *Red Directors* were found incapable of adapting.

The disintegration of the Soviet Union, the fragmentation of established economic and production relationships, high inflation, and the need to attract direct investment capital all proved to be too great a challenge for the *Red Directors* to overcome. The complex economic and political changes of the period also served to strip away the relationships, the firewall, that protected the *Red Directors* from the negative consequences of their inefficiency and self-serving stewardship.

The second stage in the development of Russian business came during the mid-1990s. The *Red Directors* were largely pushed aside by those who had captured some capital, business experience, and influence during Perestroika and were

Mid-Year 2001 Ranking Russian Insurance Companies

RANK	COMPANY	COLLECTED PREMIUM
1.	Industrial Insurance Company	$679,688,938
2.	ROSNO Insurance Group	346,938,689
3.	Yakor Insurance Company	209,592,189
4.	National SG	186,646,275
5.	Interros-Soglasie	113,171,236
6.	Liga Insurance Company	110,452,013
7.	SK Lukhoil Insurance Company	102,563,633
8.	Rosgosstrakh Systema	94,046,172
9.	Reso-Guarantiye	93,985,618
10.	Ingosstrakh Insurance Company	90,461,900

Source: Expert Magazine, Moscow (Sept. 17, 2001).

Development of the Russian Insurance industry

PHASE	YEARS	DESCRIPTION
1	1991–1993	Industry organization underway.
2	1994–1995	Insurance "profession" emerges.
3	1996–1998	Market potential recognized.
4	1999–2000	Consolidation and acquisitions.
5	2001–2002	Consumer programs emphasized.
6	2003–2004	Western participation increases.
7	2005+	Open market and rapid growth.

nimble enough to adapt to the often questionable rules of an economy in transition.

In the late 1990s, the theft of state property reached unprecedented levels as Russia rushed to privatize and establish a market economy. Enterprise ownership changed hands not to create goods and services, but to convert assets into transferable capital.

Russian folklore has been enriched with numerous stories about these *new Russians* and some possible criminal connections. Russia is really not much different from our own "civilized" societies (e.g., Italy, Japan, Korea or Chicago and New York City) where organized crime still has a mystique, especially in America where "The Sopranos" continues to be a Sunday-night television hit series.

August 1998 closed the second chapter in the formation of a Russian business elite. The new Russians were also ill prepared and incapable of protecting their capital and their country from the financial precipice of bankruptcy. The bubble burst for Russian government short-term obligations (GKOs) because promises and avarice, not real value, backed these bonds.

In this new environment, direct investment was required to restore the enfeebled Soviet manufacturing base. These challenges were undertaken by people whose experience was not shaped at Soviet-era "assemblies" or by central planning. A new generation of managers assumed leadership in the past several years, and this new breed has subtly begun to move aside the criminal element from the manufacturing, consumer, and financial services sectors.

It's understandable that organized crime is gradually disappearing from business. Mafia-related enterprises extracted value and only rarely added to it. In more practical terms, the interests of the new generation of managers have coincided with the objectives of new government authorities under President Putin. This kismet is why the Russia of today is indebted to the third factor, more effective management, for recent economic growth. And it's most visible today in the insurance sector.

Insurance has become the "stealth" industry in the Russian Federation. While other sectors have received more attention, Russian insurance companies have soldiered forward. The 10 leading companies registered about one-half of the premium in 2001 while the smaller companies continued to develop niche markets through product mix, specific customer target segments, and geography.

The Bad

Because the Russian insurance industry is a work in progress, it's not altogether surprising that Russia has seen its share of insurance-for-barter transactions, premium kickback arrangements, payroll tax avoidance schemes, and the swap of promissory notes from quarter-end to quarter-end to avoid certain regulatory reporting requirements. These bad habits are gradually being rooted out of the system as weaker companies are eliminated and more order is installed.

Certainly, as we compare the Russian economy with those of the more advanced Western countries, it's a little early to talk about Russia's role in the global insurance fraternity. But the dynamics of Russia's developing markets encourage the assumption that Russia will play a more important role in the near future. Last June, Allianz A.G. purchased a major stake in the ROSNO Insurance Group, Russia's second-largest insurer, and this move has become the standard jumping-off point for Western investigation and participation.

Several other multinational organizations are actively evaluating market entry and merger possibilities with Russian insurers as a suitable alternative to their base and other emerging markets. Russian insurers have been creative and flexible in a journey that began with the first Insurance Code in 1993 and survived two attempted *coups d'etat* and serious bouts of political theater.

While these developmental phases are a natural progression in the industry, the key elements to success in the Russian Federation will be management, product development, marketing, customer service, staff training, and professional education.

Russia has been fortunate in several ways. First, competition has a long way to go to reach the fratricidal levels common in the West. Second, the industry is a clean slate, which is gradually beginning to adopt or overlay more appropriate Western practices.

And third, the Russian people are particularly adroit in personal relationship skills and they exhibit a natural talent for salesmanship. This skill has helped spark insurance premium growth to this point, but it will now become even more important for Russian insurers to emphasize contemporary insurance education, customer service strategies, business retention programs, and sales skills that provide for and support multiple company objectives and broader client needs.

A higher value can be attached to management and distribution in Russia because of its vast territory, the complications of operating in 11 time zones, and the investment and sophistication required to establish and manage a risk business and a sales force in diverse political and administrative jurisdictions.

While many think of Russia as a mysterious and uncharted territory, it's myopic not to consider it on equal terms with Latin America, China, India, and the Pacific Rim. Growth rates can be deceptive, according to a recent report in *The Economist*. "Take China, which is reckoned to be Asia's most promising market, with 1.3-billion people. Even if insurance did double by 2005, China's market would merely rank alongside Switzerland's in size. If it doubled again by 2010, it would be equal to Italy's."

In many ways, Russia is closer to a Western-style market than many other countries. A recent report by Goldman Sachs indicated that Russia now ranks third in national savings rate in emerging markets, at 31 percent of GNP, behind only China and Singapore and well ahead of South Korea, Taiwan, Mexico, India, Argentina, Chile, and others.

And the Ugly

The business of insurance has quietly evolved to a point where it has become a success model in Russia, although some of the more exciting aspects of the *Wild West* remain attached to it. Insurance is capturing well-deserved attention, and some insurers are now affiliates or captives of banking groups and large financial-industrial groups (FIGs). Russia's eighth-largest bank and Ingosstrakh, a well-known insurance company, formed an alliance late last year with one of the country's largest aluminum groups, Siberian Aluminum, and a leading automotive holding company. Many FIGs are considered to be states within a state, accumulating power to the extent that some of them are much like street bullies with a tendency to make their own self-serving rules of behavior.

Despite the tumult, the past several years have turned out to be very successful for the development of Russian financial markets. The insurance community enjoyed substantial growth, and it should be no surprise that financial instruments and trading liquidity are now important to effective reserve and asset management. The August 1998 financial crisis and subsequent default were good lessons for most Russian businesses. The crisis modified or eliminated much of the hyperbole and the cowboy-gunslinger spirit that had influenced financial markets in Russia and elsewhere.

The 1998 crisis was the turning point in post-Communist history when financial and investment risks were seriously considered from a practical and deliberate point of view in Russia. At the same time, a sense of vulnerability and uncertainty shifted the thought process to the extent that risks of various kinds needed to be confined.

Russian State Savings Bond for Non-Market Borrowings General Characteristics

Investors	Insurance companies, state and non-state pension funds, mutual funds, and certain investment funds
Face Value	1,000 rubles
Issue Form	Global depositary certificate
Distribution	Auction
Secondary Market	No
Maturity	1.5 to 10 years
Coupon Period	6 months
Trading System	Tender basis
Specific Options	Bond swapping to other market state bonds
Coupon Rate	Variable
Coupon Yield	CPI + premium

One of the main reasons for rapid premium growth has been the introduction of new insurance products that hadn't been in demand. The Russian insurance community quickly managed to find ways to meet demand with a broad array of products and services. The fallout from the collapse of financial pyramids and substandard investments, as well as of the banking crisis that followed, caused individual investors to look for savings alternatives. This became an incentive in the development of long-term insurance, which is referred to in Russia as traditional, or accumulation insurance.

The accompanying growth in insurance reserves has required insurers to diversify their investment portfolios and to create realistic investment policies. Some positive tendencies now seen in Russian financial markets certainly give the insurance community reason for optimism. These developments include an organized market for corporate bonds, a liquid securities market with sufficient capacity, and the development of mortgage instruments to support more balanced, secure investment portfolios.

The investment portfolio of a Russian insurance company had always been based on state treasury bonds, on financial instruments with hedged risks, and in real property holdings registered in the form of securities. It wasn't expected that, after the 1998 default, the turnover and the capacity of the state fixed-income market would quickly recover to its pre-crisis state.

Financial instruments specifically designed for institutional investors are expected this year. New insurance and pension products are being introduced and linked to modern investments. Further, the experience gained by the insurance community, working together on investment policy, will serve Russia well as the All Russia Insurance Association (ARIA) tackles other mutual problems. The development of state bonds and a bond market, the introduction of new financial instruments, the development of a financial derivatives market, and the approval of state and non-state mortgages are main goals of the insurance community. The State Savings Bond for Non-Market Borrowing is the first new security.

These new bonds required certain approvals and supporting regulations from the Russian government and certain "orders" from the Finance Ministry. After substantial study and coordination, led by ARIA, the regulations and administration procedures have been approved for implementation.

Russia had been hamstrung by a deficit of more secure financial instruments and market liquidity. This experience is rapidly changing as the market enters a new growth cycle and as the industry tries to keep pace with product demand. Other goals include efforts by both the investment and insurance communities to encourage confidence in Russia's financial markets.

The absence of a range of maturity choices in Russian financial instruments remains an obstacle to further development of the Russian insurance market, to the introduction of the new insurance products, and to the creation of insurance investment portfolios, with balanced terms and risks. More attention will be required.

Consumer and commercial insurance needs are increasing throughout Russia. Demand is growing at a rate estimated to be five times faster than the rest of the economy because of a stronger economy, more disposable income, and an increasing awareness of the advantages of insurance.

The personal lines market is at a threshold stage as the Russian consumer, now flush with personal property and cash savings, looks for ways to buy protection. There is a growing requirement for wealth and asset protection, and generational wealth transfer will become important as the middle class expands. Retirement security and pension supplements are important to Russia's aging population as the government privatizes much of its responsibility. Personal lines insurance will become the industry leader.

The better Russian insurance companies are becoming attractive partners for Western insurance groups looking to expand to a Western-like market. More important, there's room for start-up Russian insurance companies if accomplished in combination with Russian insurance professionals, many of whom are very motivated to work with and learn from their Western counterparts.

Competition has many faces for Russia. The Russian insurance sector is in the midst of a competition for investment funds. Market development, at this stage, requires outside capital. Financial and operational leverage can be maximized, and any new capital will have an exponential impact on market expansion.

There is competition to show Russia as a legitimate country, qualified for outside investment. There's also competition to demonstrate that the insurance industry can organize and generate an acceptable return on investment. We should recognize that there will be an absolute competitive advantage for those investors and project organizers who choose to become involved in the near term in Russia. Next-stage market entrants will become part of an exit strategy as they come to realize that Russia is unique to the business of insurance.

Russian insurers look to grow through the application of Western capital, and they're eager for insurance technique and technology transfer. Their economy has achieved stability and is improving, and, as a result, insurance assets are under-valued relative to their longer-term potential.

The Russian insurance market potential remains under-appreciated, but it is, and will be, a factor to be recognized. Demand is accelerating, and current capacity to provide a full range of insurance products and services is limited. Further, with disposable income growing and personal assets being acquired, Russians are beginning to act like their slightly more predictable Western counterparts.

The Russian Federation has survived a difficult 10 years and is beginning to thrive. Risk awareness is now a part of the landscape. Given the alternatives, the West still prefers the new Russia, with democratic elections and an emerging market economy, rather than Russia as an "adversary with an attitude." Russia has achieved stability and the economy is improving; the people are becoming consumers with a spending passion, and Russia is certainly now one of the last, and increasingly promising, insurance frontiers. ●

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