March 30, 2017

OMTPL and investment insurance risks threaten growth stability

Russian insurance market 2021 outlook

- **Insurance market is to climb 8.8% in 2017**, which will be a less spectacular result than the one shown last year (15%), although it should still outstrip Russian economic growth projected for this year (5.8% in nominal terms). Low penetration of insurance services in Russia will provide for high growth rates in the sector, with annual market growth expected at 11% within the 2017-2021 horizon.

- **Population aging and monetary policy to support rapid growth of life insurance.** In 2016, the segment posted a phenomenal growth of 66% y-o-y, with the main contributor being investment life insurance fostered in turn by banks' active involvement in insurance policy sales and by lower deposit interest rates. A moderately tight Bank of Russia policy aimed at maintaining positive interest rates should provide an impetus to further growth in the segment, provided that clients are happy with investment life insurance results.

- **Car sales growth this year to push motor premiums up.** Motor hull policy sales shrank in 2015-2016, but new car sales are expected to resume growth in 2017-2021 stimulating a premium increase in both motor hull and OMTPL segments. The latter's climb is to be supported by an expected increase in the proportion of insured vehicles.

- **Insurance market growth rates to outpace average economic performance** in the medium term, which will have a positive effect on insurer credit profiles, however...

- **...sustainability of this growth raises concerns.** In the short term, the greatest risks are associated with the OMTPL crisis, while on the two to three-year horizon a dramatic decline in life insurance premiums seems possible.

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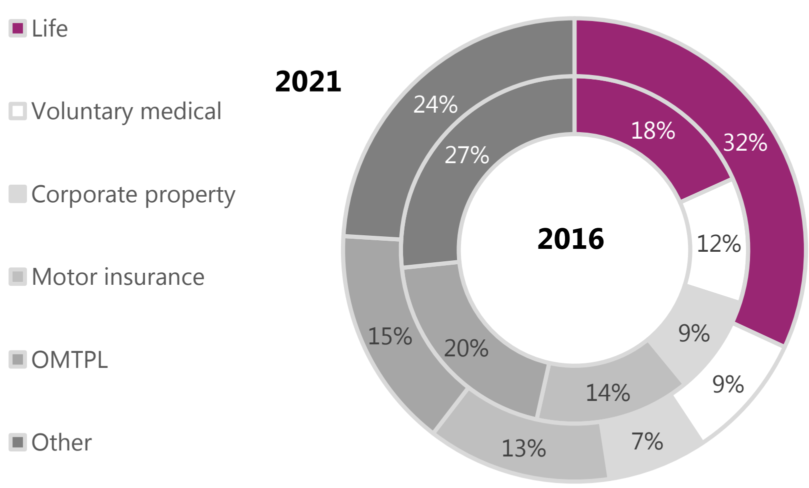
Table 1. Insurance premiums forecast for 2017-2021

Indicator	Measurement Unit	Actual number			Estimate	Forecast			
		2014	2015	2016	2017	2018	2019	2020	2021
Life	**RUB bln**	**109**	**130**	**216**	**269**	**329**	**401**	**482**	**638**
Growth rate	%	27.8	19.5	66.3	24.8	22.3	21.6	20.3	32.4
Share in total	%	11	13	18	21	23	25	27	32
Voluntary medical	**RUB bln**	**124**	**129**	**138**	**142**	**150**	**159**	**168**	**176**
Growth rate	%	7.9	3.9	6.9	3.2	5.5	6.1	5.7	4.7
Share in total	%	13	13	12	11	11	10	10	9
Motor hull	**RUB bln**	**219**	**187**	**171**	**175**	**195**	**220**	**242**	**257**
Growth rate	%	2.9	-14.3	-8.8	2.6	11.3	12.9	9.7	6.6
Share in total	%	22	18	14	14	14	14	14	13
OMTPL	**RUB bln**	**151**	**219**	**234**	**255**	**281**	**292**	**301**	**310**
Growth rate	%	12.4	44.9	7.2	8.9	10.1	4.1	3.1	2.8
Share in total	%	15	21	20	20	20	18	17	15
Corporate property	**RUB bln**	**112**	**100**	**107**	**114**	**119**	**128**	**133**	**138**
Growth rate	%	7.6	-10.9	7.5	6.0	4.7	7.0	4.3	3.5
Share in total	%	11	10	9	9	8	8	8	7
Other	**RUB bln**	**274**	**259**	**315**	**328**	**349**	**390**	**432**	**481**
Growth rate	%	7.6	-5.2	21.3	4.4	6.2	11.7	10.8	11.4
Share in total	%	28	25	27	26	25	25	25	24
Total	**RUB bln**	**988**	**1,024**	**1,181**	**1,284**	**1,423**	**1,589**	**1,758**	**2,000**
Growth rate	%	9.2	3.6	15.3	8.8	10.8	11.7	10.6	13.8

Source: ACRA estimates, Bank of Russia reports[1]

Figure 1. Comparative market structure analysis of 2016 and 2021



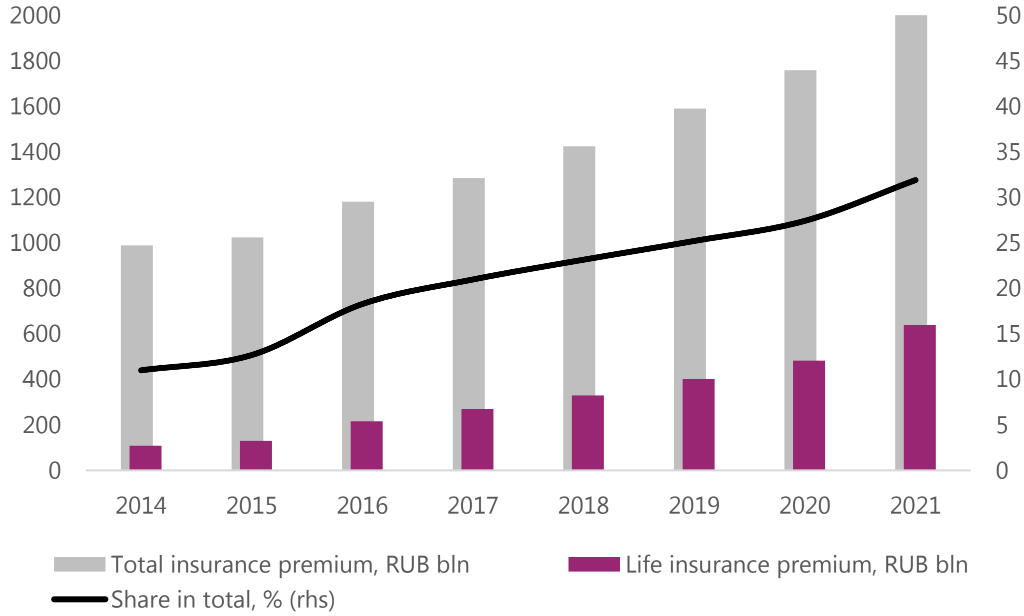
Source: ACRA estimates

[1] Growth rates and market shares in 2014–2016 were estimated on the basis of Bank of Russia statistics.

Confidence in life insurance has strengthened

Life insurance remains the most dynamic segment on the Russian insurance market. Its rapid growth in 2016 (+66% year-on-year) was primarily owed to the expansion of investment insurance.

Figure 2. Life insurance share in total premium will continue its steady growth



Source: Bank of Russia, ACRA estimates

We keep holding the same opinion on the triggers for such outstripping growth that was stated in our previous version of outlook, namely:

See the ACRA October 14, 2016 research "Life insurance takes market lead, car insurance is driven back."

"The fast-paced growth of investment life insurance is attributed to the combined effect of the following factors:

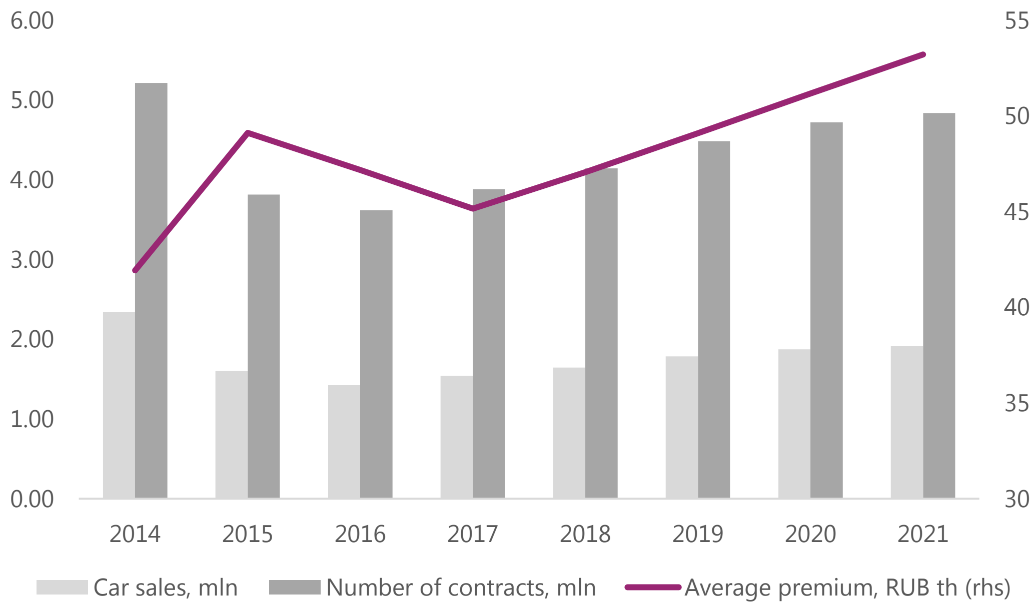
- Insurers have launched a new "packaged" product that requires no underwriting and can be sold through the banking channel.
- In the face of a lending decline, banks are showing interest in investment life insurance as an additional source of commission income.
- Clients see investment life insurance as an alternative savings tool that both guarantees a return of capital and gives them access to various investment products (including those on foreign markets). The recent deposit rate reduction has sparked a keener interest in this product."

ACRA expects life insurance to continue its outstripping growth in the medium term, if insurers are able to show satisfactory investment insurance results. In this case, the future will see the population increasing focused on traditional types of life insurance, primarily to endowment plans. At the same time, customer discontent with investment insurance results may seriously undermine life insurance sector's prospects in general.

Motor insurance to climb moderately

After two years of decline, motor hull insurance premiums are expected to climb 2.6% in 2017, with is to be followed by a projected average increase reaching 10.1% over the four succeeding years. The segment dynamics will be defined by an anticipated new car sales increase. ACRA also believes that the potential for further reduction in the average insurance premium is limited.

Figure 3. Key motor hull segment factors to start rising in 2017



Source: AEB, ACRA estimates

Motor hull was the only important insurance market segment that posted a decline in 2016, dropping 8.8% on the back of the shrinking average insurance premium after its substantial increase the previous year. The negative trend was also supported by a continued reduction in the number of contracts signed amid a sharp fall in new car sales.

Starting 2017, ACRA forecasts new car sales to climb along with expected economic situation improvement. This growth is to be fueled by pent-up demand and to stabilizing household income.

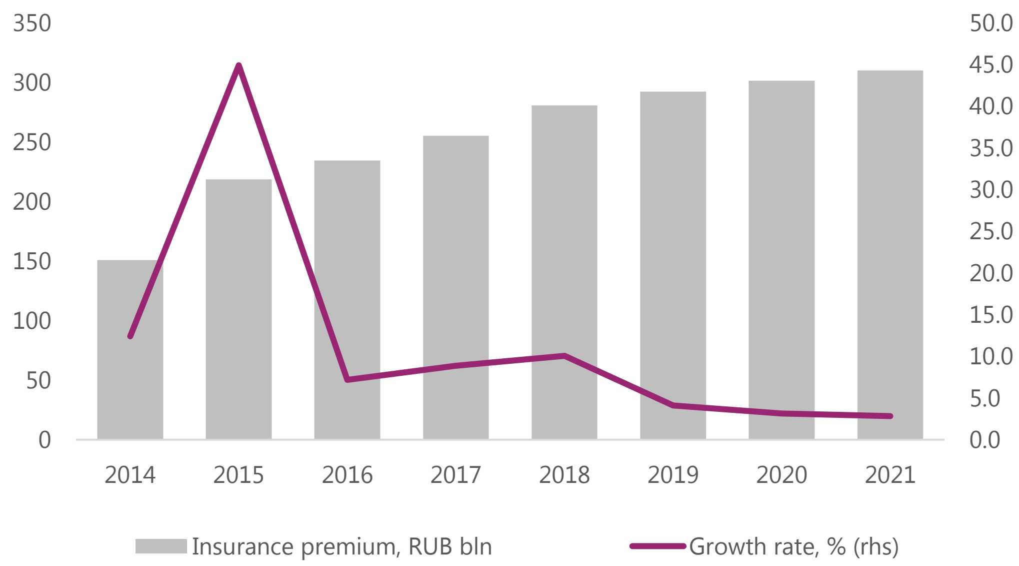
By our forecasts, in 2017 the average premium per policy, which was suppressed in 2016 by a massive rollout of insurance with a deductible, should continue to decline, although the segment is still likely to show nominal growth. However, a further decline in the average premium may jeopardize operating income of motor insurers, which might well face losses in the OMTPL segment. In this regard, ACRA expects the average premium per policy to start growing since 2018, pushed up mainly by inflationary processes.

OMTPL premiums to climb due to growing proportion of insured vehicles

In 2016, OMTPL premiums climbed due to a residual effect of the tariff increase that took place in April 2015, although the declining number of new contracts was restraining the positive trend. By end-2015, the number of current insurance contracts slid to a five-year low, while the number of motor cars over the year increased by more than 15%. ACRA associates the declining proportion of insured vehicles with shrinking real household income, fake insurance policies, and low insurance availability in some regions.

Starting 2017, the share of insured vehicles is expected to recover to the level of 2012-2014. We believe that the initiatives by the Bank of Russia and the Russian Association of Motor Insurers aimed at preventing the use of fake insurance policies and build up insurance availability (through the Single Agent system and e-policies) will provide for growth in the total of insured car fleet in Russia. The positive effect should also come from a projected stabilization of real disposable income.

Figure 4. Tariffs to stay flat, OMTPL to grow further



Source: Bank of Russia, ACRA estimates

See the ACRA June 7, 2016 research "OMTPL: Higher Chances for Change."

In view of the electoral cycle, the tariff adjustments are unlikely before 2019. But even after the 2018 elections, limitations for OMTPL tariff growth will remain: the post-election period is to see a number of postponed socially sensitive reforms concerning taxation, pensions, and housing. Their implementation is expected to seriously affect household welfare.

Corporate property insurance and VMI to grow at moderate pace

ACRA's view of the corporate property insurance and voluntary medical insurance (VMI) segments has remained unchanged, with insurance premiums here expected to climb proportionately to macroeconomic indicators in the medium term.

Corporate property insurance should benefit from further monetary stabilization, in particular from lower interest rates and increasing loan availability for the real sector. Low fixed investments will restrain premium growth.

Given the expectations of relatively weak macroeconomic dynamics, ACRA believes that VMI premiums will keep on showing slow growth until 2021. The segment may return to growth in real terms after the economic situation improves and the labor market undergoes changes favoring employees.

Changes to developer legislation will negatively affect other insurance types

In 2016, the segment of other insurance types posted a considerable in aggregate growth by 21.3%, with the largest contribution to this growth made by accident insurance (+33.5%) and liability default insurance (+204%). The latter in turn was mainly piled up by real estate developer liability insurance.

In view of the projected household lending growth, ACRA believes that the positive trend in the accident insurance segment will continue. Further growth is also expected in the segment of individual property insurance. The low base effect in this segment is supported by the government interested in reducing pressure on the budget by means of supporting market mechanisms of safeguarding the population from consequences of natural disasters. Insurance companies also contribute to sector growth by actively promoting cross sales to car insurance and VMI clients.

The amendments made to the law “On sharing commitments in the construction of apartment houses and other items of estate property and on amendments to some legislative acts of the Russian Federation” are expected to significantly reduce liability default insurance premiums, as insuring developer liabilities will no longer be mandatory. This factor will have a significant impact on the general assessment of insurance premiums in the segment where growth is expected to run into just 4.4% in 2017.

Systemic risks jeopardize market growth and insurer creditworthiness

A comparison of the forecasted GDP dynamics with total insurance premiums shows that the insurance industry is ballooning faster than the economy. In 2017-2021, nominal GDP is expected to climb on average by 5.9% annually versus some 11% of relevant growth projected for the insurance market. This is due to the modest share of the insurance sector in the Russian economy compared to developed countries. Thus in 2015, Russia saw its total insurance premium standing at 1.2% of GDP, while in the US, this figure reached 7.3% and ranged between 5% and 12% across Western Europe, according to Swiss Re.

At the same time, the insurance market is facing increasing systemic risks that may undermine expected growth rates. In the short term, the most pronounced risks are connected with the OMTPL crisis. Although implementation of e-policies and the Single Agent system increased obligatory motor insurance availability in problem regions, it has so far failed to curb the loss-making trend for insurers. That said, the ongoing discussion of a legislative initiative regarding in-kind indemnities imbues sector players with hope for stabilizing OMTPL income. Under a negative scenario, the segment may well see insurers giving up licenses or going bankrupt, with the state building up its direct presence, possibly through inception of a dedicated government-run SPV.

In the next two to three years, the sector might confront the risk of policyholders growing disappointed by investment life insurance. Presently, insurers and banks adhere to an aggressive sales tactics by offering the population what in fact may be called a rather complex structured investment product underpinned with investment return guarantees. At the same time, it seems obvious that insurers are counting on income exceeding the usual deposit interest amount. Intermediary fees that constitute a significant part of the premium negatively impact the final result, which may well run the booming life insurance segment into a real shock, should investment insurance policies bring about weak returns.

Expected market growth is positive for the external environment factor assessment and, consequently, for insurers' credit profiles. That said, some insurance companies might well see their credit profiles under pressure, should the aforementioned systemic risks materialize.

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