Moscow
07/07/2014

Policy Recommendations for Long Term Finance in Russia: Pension and Insurance markets

Introduction

The work stream on Long Term Finance (LTF) was set up in summer 2013 at the Joint Liaison Group (JLG) meeting in Moscow. A two-phase working plan was suggested. The first phase (September-October 2013) was focused on the challenges for the development of LTF in Russia. The second phase (January-June 2014) was dedicated to solutions and policy recommendations with a comprehensive joint report as a final output.

Our first interim report was presented in December 2014 at the JLG meeting in London. The report considered the challenges for the development of LTF in Russia and served as a starting point for the second phase of LTF work stream. Initially the second phase assumed extensive consultations with the UK counterparts during the visits by Russian experts to London in February-April 2014. However, for a number of reasons the trips to London had to be called off. This prompted the correction of initial plans for the second phase. We agreed to narrow the scope of our policy recommendations and to focus them mainly on two industries: pension and insurance.

Our new report summarizes the findings of LTF work stream during the second phase of activities. The report outlines solutions and policy recommendations for two industries related to LTF: pensions and insurance. It reflects the proposals kindly provided by Matt Lilley, Sonal Kadchha and their colleagues from Prudential plc in response to the discussion the paper on solutions and policy recommendations, drafted by Russian experts.

We express special thanks to Goetz Kuras from Oliver Wyman for his valuable insights, comments and information support.

All the policy recommendations presented in this report do not necessarily reflect a consolidated opinion of the LTF work stream participants and are supposed to serve as preliminary proposals to be discussed and reviewed during follow up activities of the work stream.

1. Pension funds

Market parameters.

Non-state pension funds (NPFs) participate in providing both voluntary and mandatory pensions. Employer-sponsored pension plans dominate the voluntary pension market. Mandatory pensions are provided by both NPFs and the Pension Fund of Russia (PFR). The latter has both more participants and much of the assets in the mandatory pension scheme. Pension funds may not invest mandatory contributions on their own. These are invested by asset management companies, and the PFR assets are managed by the State Asset Management Company with its functions performed by Vneshekonombank. Its investment portfolio mainly comprises government securities (marketable and non-marketable); investing in stocks is not allowed. Voluntary contributions are partly invested by NPF independently. As of end of 2012, total pension assets could be estimated at 5 per cent of the GDP, of which NPFs accounted for 2.3 per cent.

Current situation.

In 2013 mandatory component of pension system was overhauled. Contributions vacations were declared for 2014 - funded pillar contributions will be redirected to PAYG system. Meanwhile NPFs are to change their legal form from non-profit to commercial (joint stock companies) and enter the newly established guarantee scheme. Only then transfer of contributions to NPFs could be resumed. This is the case not only for the mandatory pension contributions but also for maternity capital and so called co-finance program. Contributions to these schemes will not go to the PAYG system but the transfer to NPFs is suspended.

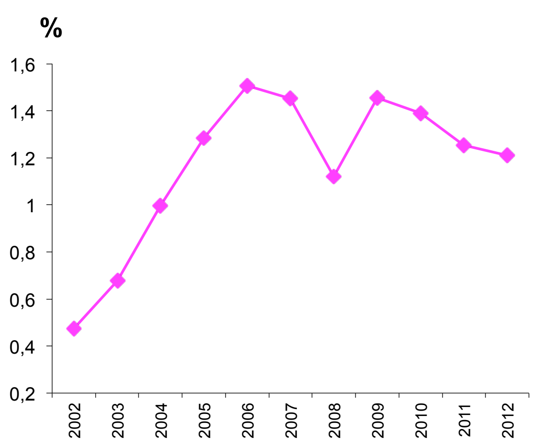


Fig. 1. Pension reserves of NPFs as percentage of GDP.

Since 2015 contributions of the members of mandatory pillar who did not chose NPF will go to notional accounts in the PAYG system. Thus the flow of pension accumulations to NPFs will slow down drastically and new drivers for growth are to be found. One is development of voluntary pension schemes. This component accounts for roughly a half of NPF assets. But shortly after the introduction of the second pillar development of this form slowed down and pension reserves of voluntary schemes began to lose its relative weight in the economy (fig.1). Since 2007 the number of members of voluntary schemes ceased to grow and remained below 7 mln. (less than 10 per cent of employed).

Individual investment accounts to be introduced in 2015 could boost development of personal pension plans but these could be open with brokers and asset management companies, not with NPFs. Thus, mandatory pensions remain the most important form for NPFs and competition for accounts of insured persons gets tough.

Regulation and supervision.

The current system of supervising NPFs is based on the state setting portfolio limits and requirements and focuses on the control over market participants' complying with these limits and requirements. The internal control mechanisms in pension funds do exist but are oriented toward ensuring that legal norms are complied with and not aimed at evaluating the riskiness of the business. At the same time, the activity of the NPF may be overly risky without actually violating any laws. This approach does not allow effective control over risks in the funded pension system and is not tuned to enable the NPFs to fulfill their key role – to generate pension income for system participants and beneficiaries, to ensure the stability of the way pension funds, and the funded pension system overall, function.

To reach these goals prudential approach to supervision is proposed. In its context the center of the supervisor's attention should be the ability of pension funds to adequately access and manage the risks they face. Objectives of the supervisor thus shift to evaluating business processes and risk management mechanisms. The supervision should include NPFs themselves, asset managers (AMs), who manage their assets, and specialized depositaries (SDs) as well as risk controls and investment policy with respect to the various available investment instruments. The financial stability of NPFs needs to be evaluated under different macroeconomic and market development scenarios. Supervision of NPFs should become risk-based. If implemented this approach will enhance the sustainability and efficiency of both mandatory and voluntary pension schemes and that is why it was chosen as a centerpiece for this part of the note.

Proposals for reshaping the industry and its regulation.

To attain the objectives, the improvement of NPF governance is necessary. Introducing prudential risk-based supervision in the pension industry should be done in parallel to deep changes in culture, mindset, procedures, and technologies that are used by NPFs, their AMs, SDs, actuaries and pension account administrators. The change of the legal form of NPFs is only a prerequisite of moving to risk-based prudential supervision.

The transformations must happen both on the regulator level, and that of regulated entities (NPFs, AMs, SDs, pension account administrators, actuaries). Then, as a result, it will be possible to move away from a bulk of the currently set legal limits on investing pension assets.

To change the situation relying mainly on legislative tools, as experience from other markets shows, is not sufficient. Stated goals require complex changes which cannot be done in one step, that is why a phased approach to introduction of prudential risk-based supervision is proposed.

When developing the architecture of a risk-based supervision, it is necessary to take into account the specific nature of the pension industry:

- long horizon of investing pensions assets
- lower, by comparison to banks, liquidity needs at the stage of forming the pension assets
- need to manage biometric risks

- active role of the asset managers in investing pension assets, and at that, as a rule, the structure and maturity of NPF obligations to their members and beneficiaries are not taken into consideration by the asset managers
- control over the investment process by specialized depositaries, which do not play a material role in the banking sector
- most of NPFs engage in two types of business – mandatory pension insurance and voluntary pension provision. Working in the voluntary pensions market means servicing some commercial clients, offering them defined benefit or defined contribution schemes, offer individual savings plans to individual clients, and at that their assets are pooled at the investment stage regardless of the fact that those clients have different risk profiles
- some NPF functions can be fulfilled by pension account administrators, who are not supervised within the scope of Central Bank of Russia (CBR) mandate
- the state Pension Fund of Russia plays a special role in the mandatory pension system.

All of the above implies specific issues to be dealt with by risk-based supervision and must be accounted for when designing its architecture.

The main elements of transition to prudential risk-based supervision:

- <u>Strengthening of risk-management in NPFs and other institutions that participate in the mandatory pension system and the voluntary pension market</u>

Adequate risk management process in an NPF requires not only measuring and controlling portfolio risks and ensuring compliance with the laws, but also a consistent and integrated process of asset and liability management (ALM*)*. The risk management system must also cover biometric risks.

To achieve that, changes in NPF internal controls are necessary. Internal control systems should include not only compliance control, but also such elements as evaluating the effectiveness of activity, compensation mechanisms, IT systems and processes and risk management procedures. Internal NPF control standards based on risk assessment must reflect the organizational and administrative procedures that have a key impact on controlling risks and sound business practices[1].

---

[1] including:
1. The regular assessment of the effectiveness of persons and entities' with operational and oversight responsibilities in the fund. Including the need to put in place indicators (benchmarks) for external asset managers and regularly evaluate the their performance using these benchmarks. Indicators/benchmarks need to be regularly reviewed to ensure they are aligned with the objectives of the fund.

2. Regular review of compensation mechanisms to ensure that those who are responsible for operations and supervision of the fund are property incentivized.

Organization of a compensation commission may help to increase the transparency of fund administrative expenses including money spent on compensation outside contractors and members of the management team. Particular attention should be paid to the compensation policy with respect to marketing staff and agents of the fund who have a mandate to enter into obligatory pension contracts on behalf of the fund, since these expenses may substantially decrease pension payouts. There is also a risk that these employees may not act in the best interest of the fund members and beneficiaries. Thus, the management

- Changes in the investment management procedures

In the process of preparing for implementing risk-based supervision the optimal level of liberalization of investment (portfolio) limits must be defined. This decision is critical for the depth of transformation that will happen in NPF corporate governance systems, asset managers, specialized depositaries and, most importantly, in their risk management systems, as well as the general effect from transforming the supervision and regulation systems.

Strengthening risk management in the area of managing investments necessitates that the fund's management body implements a robust and thoroughly thought out process that governs investment, including conducting internal audits and following procedures meant to exercise effective control over the investment management process. To implement this principle, it's proposed to:

1. Mandate NPFs to create an investment committee and those NPFs that offer defined benefit schemes are to set up ALM committees, the functions of which are to adhere to standards developed by the self-regulating organization. The committees' mandate, among other things, must include developing strategic pension plan asset allocations and setting limits on investment activity.

2. Set requirements with respect to the qualifications of fund employees who are involved in making investment and set up control over them (when delegating such functions to an asset manager).

3. Mandate that asset management contracts may be entered into only with those asset managers who have agreed to follow prudent principles in accordance with standards developed by self-regulating organization (SRO) and which have acceptable risk management systems.

4. Amend requirements with respect to the NPF investment policy. It is necessary to mandate that the investment declaration which reflects the investment policy of the fund must define for each specific pension scheme:

- the strategic (long-term) asset allocation along the main asset categories
- the ways in which monitoring and any required changes to asset allocation are carried out
- target indicators that define the acceptable degree of deviation from the strategic target asset allocation in light of various market and liability profile changes.

---

body must ensure that the compensation structure for such employees does not create the wrong incentives and does not lead to improper decisions being made on behalf of the fund's members.

3. Regular revision of information procedures, operational software and accounting/reporting systems.

4. Identification, monitoring and, if necessary, correcting conflicts of interest. If a management body cannot resolve a conflict of interest, it should notify the regulator, who will then decide whether the situation is permissible and on what conditions.

5. Mechanisms to prevent unauthorized use of confidential information;

6. Implementation of an adequate risk measurement and management system, including effective internal audit

7. Regular review of compliance control systems.

The investment declaration must also contain general decisions relevant to the strategic asset allocation, choice of assets and executing transactions. The investment declaration must account for the short and long-term liability profile of the pension scheme, including relevant actuarial and financing issues that may affect the liabilities.

The investment declaration must specify whether internal or external investment professionals will execute investment activity. For investment professionals the declaration must define:

- the procedure for selecting them and controlling their activities
- their mandate and responsibilities
- costs of managing investments and related activity, including expenses incurred on market research, carrying out trades and compensating external service providers.

Asset management contracts with external managers must include benchmarks to be used by the fund for evaluation of the manager's performance. According to already adopted amendments to the law this will be mandatory since 2015. The CBR is to supply methodology for these benchmarks.

Investment policy for pension schemes where members make investment choices must ensure that members have investment options (portfolios), including default options, and have access to information that will enable them to make such choices. In particular, the investment declaration must classify investment portfolios in accordance with the level of investment risk that members are exposed to when making a particular investment choice.

At the starting stage, the key role in developing methodology and requirements with respect to the investment declaration content can be played by the SROs, but the study of foreign experience shows that at least some of the requirements must be prescribed in the laws.

The fund must have procedures and criteria that the management body will use to regularly evaluate the effectiveness of its investment policy and identify the need to make changes to the policy, means by which it is executed, decision making structures and responsibilities related to developing, executing and critically evaluating the investment policy. These must be formalized via internal protocols. It makes sense for the SRO to develop such procedures and criteria.

Methodologies used to evaluate fund assets must be transparent for the fund's management body and for all those involved in the process of managing the fund's investments. Valuations and methodologies applied must be easily accessible or disclosed to the fund's members and beneficiaries.

- Actuarial valuations of pension schemes

Actuarial standards must, among other things, contain requirements to use prudent actuarial assumptions, prudent discount rates to value liabilities which must be consistent with the methodology used to valuate assets. They must outline recommendations with respect to the factors that must be used in determining discount rates for maturing liabilities.

- Changes in regulating and supervising NPFs, asset managers and specialized depositaries

Supervision over the activities of pension funds and other institutions involved in the mandatory and voluntary pension systems, should be risk-based to mitigate potential risks to the pension system. Risk-based supervision is defined by the International Organization of Pensions Supervisors (IOPS) as a structured approach that is centered on the identification of potential risks faced by pension schemes (funds), and assessment of the availability of financial and operational capability to minimize or mitigate these risks.

The transition from the current system of supervision to the risk-based approach would require a change in the applicable law and the implementation of measures for the restructuring of the supervisory authority. The timeline must be consistent with measures to strengthen risk management in pension funds and other institutions involved in the mandatory and voluntary pension systems.

One of the important differences between the risk-based approach and the current system is that in the risk-based supervision approach, preventive measures are widely used to prevent problems before they occur or escalate. To do this, at the disposal of the supervisory authority should be adequate tools to measure the resistance of NPFs to various types of risks they face, including the following that need to be developed:

- regulatory standards, including recommendations for minimum standards of risk management. The emphasis in these documents should be on the architecture of risk management in the supervised institutions and procedures of risk management they are to have;
- rules for solvency (capital adequacy in cases where it is needed, i.e. defined benefit pension plans and defined contribution plans with guarantees);
- risk assessment models to be used by the Central Bank; on the basis of these the need for remote and on-site inspections is determined;
- methods for assessing the adequacy of the internal decision-making processes in the NPF and its bodies.

The stages of the transition to a risk-based prudential supervision in the mandatory and voluntary pension systems

It is proposed to introduce risk-based prudential supervision in the pension industry in two steps.

At the first stage the conditions necessary for the introduction of risk-based prudential supervision in the mandatory pension system and private pensions market are prepared. The first stage also provides for a pilot project, on a voluntary basis, of implementing risk-based supervision principles in NPFs, asset managers managing pension accumulations (pension reserves), and specialized depositories.

The second stage provides for the extension of prudential risk-based supervision on a mandatory basis for all NPFs, asset management companies managing pension accumulations (pension reserves) and specialized depositories. This should be preceded by an analysis of the results of the pilot project and making the necessary adjustments to the regulatory framework including a review of quantitative limitations on investing of pension assets. For example, investment in stocks will enhance the effectivity of the system, and, in due time, quantitative restrictions to such investments can be removed in the context of asset-liability matching.

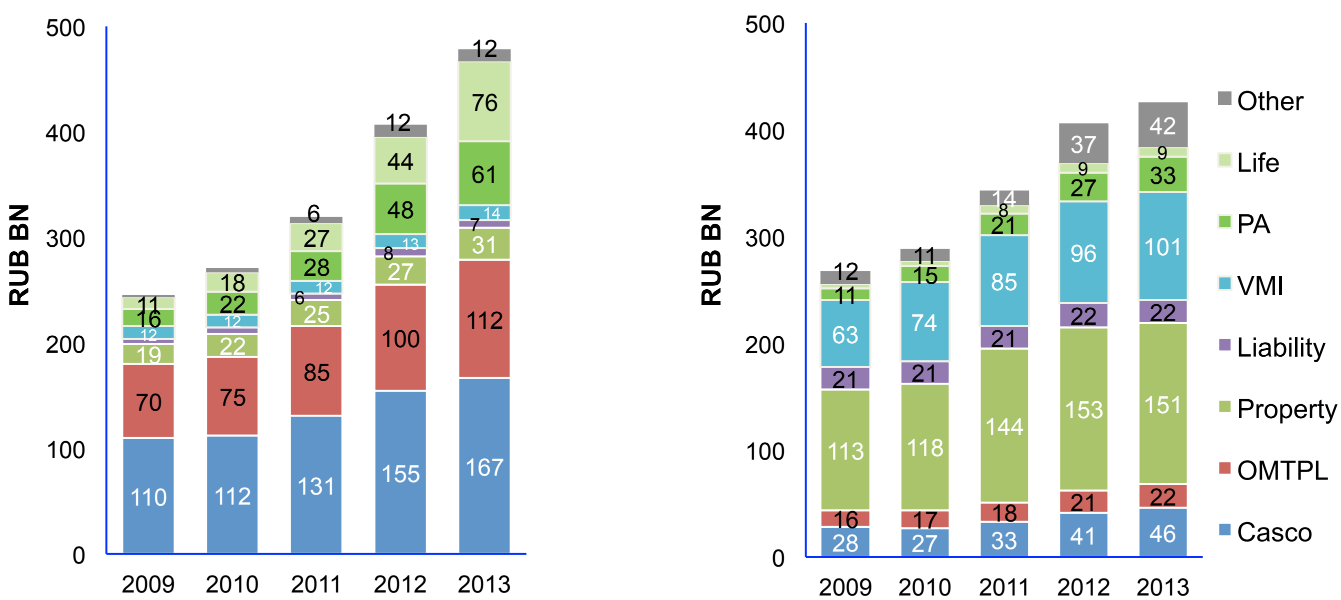
2. Insurance market

Market parameters.

The insurance industry in Russia is relatively small. In 2012 insurance companies' assets in Russia were 1.8 per cent of the GDP. As a percentage of GDP Russia's insurance companies' assets lag behind Columbia and Brazil and are a long way behind countries such as South Africa. At the same time, the Russian non-life insurance market produced annual written premiums of USD 18.5 billion in 2012 making it the 13th largest non-life market in the World. Thus, growth of the insurance sector has been driven by non-life insurance policies. The Russian non-life insurance and reinsurance markets have strong long term potential but still have some way to develop. In 2010 life insurance was less than 2 per cent of the total market (compared to a world average of about 50 per cent) but was growing fast. In 2013 its share went up to 9.4%.

After the financial crisis, rebound of the economy and credit drove fast growth particularly in Life, PA and Property (retail and commercial) - fig. 2.

Retail market revenue pools (ex. OMI*) **Corporate market revenue pools (ex. OMI*)**



Source: Oliver Wyman, official insurance regulator figures
*Obligatory Medical Insurance (OMI) is excluded from analysis due to absence of risk transfer under it.
Property = total property including financial risks – CASCO.
Liability = voluntary liability + obligatory liability – OMTPL
Other includes entrepreneurial and financial risks, obligatory personal insurance and other minor insurance products

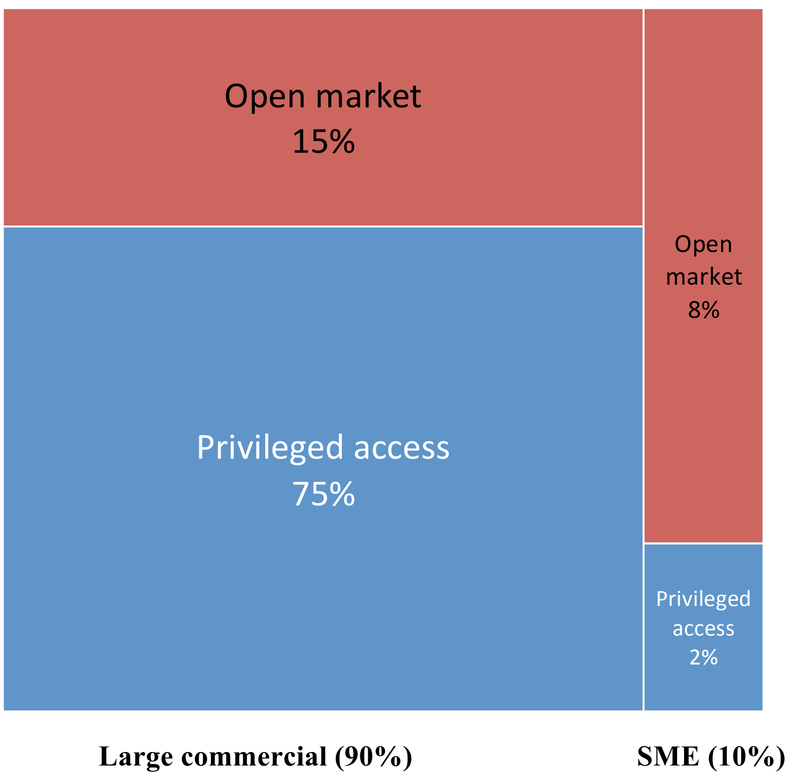
Fig. 2. Dynamics and structure of the Russian insurance market.

The rate of insurance penetration is still low in both the private and corporate sector. In 2011 penetration of insurance (gross premium/GDP) in Russia stood at 1.2% as compared to 13.7% in SAR and 2.5% in Brazil. OECD countries total stood at 9%[1]

Main market segments.

Mandatory insurance includes: mandatory personal insurance of passengers (tourists, excursionists), state personal insurance of employees of the State Tax Service, state insurance of military and persons equivalent, OMS and OSAGO[2]. OMS represents the largest share and fastest growing line of compulsory insurance.

The main categories of *voluntary insurance* are personal, property and liability insurance. Voluntary personal insurances comprises health and life insurance. Premiums of the various life insurance lines are very limited with overall premium levels small. Premiums of traditional life insurance have even fallen in recent years. Other life insurance lines such as annuities, unit linked, and pension products have small proportion of the life business.



Source: Oliver Wyman

Fig.3. Commercial insurance premium breakdown, 2012 estimate

[1] According to OECD insurance indicators - http://stats.oecd.org/Index.aspx?QueryId=25437

[2] OMS - Mandatory health insurance, OSAGO - Mandatory motor third part liability insurance

Voluntary property insurance is the largest proportion of the voluntary lines. It constitutes mainly commercial transportation insurances, agricultural insurance and property insurance for legal entities and individuals. Insurance of land vehicles is the largest line of property insurance. Voluntary liability insurance is a small part of voluntary non-life insurance. Overall, it constitutes less than 3% of the insurance market.

According to Oliver Wyman estimates (fig.3), insurance premium is equally split between retail and commercial premium, but profits are concentrated in the commercial segment with a close to 90/10 split between commercial and retail profits. Open market has an estimated 10% of commercial profits. Competition in the open market is concentrated on large commercial as SME requires distribution infrastructure. Commercial premium structure reflects Russia's economic structure:

- 79% of GDP are created by large companies
- Many large companies are close to the State
- 21% of GDP are created by SMEs.

Market structure.

Up to 2009, there have been more than 700 insurance companies operating in this small market. Increased minimal capital requirements introduced in 2012 caused a major reduction in their number (432 companies as of end-2013).

Table 1. Number of insurance companies and insurance brokers

	2007	2008	2009	2010	2011	2012	2013
Number of insurance companies and insurance brokers	944	913	846	790	760	641	…
Of which insurance companies	857	786	702	625	579	469	432

The major players in the insurance market are either former state monopolies, insurers in which the state has a significant stake, or foreign-controlled insurers.

Moscow is by far the main insurance market in Russia. The insurance markets of other major cities, such as Saint Petersburg, Nizhniy Novgorod and Ekaterinburg are small in comparison. A small amount of business from other CIS countries reaches Moscow.

There remain significant barriers to entry and operation of foreign insurers though several international insurance and reinsurance groups already have a presence in Russia including Ace, AIG, Allianz, RSA (In-Touch), Zurich, Scor and Munich Re. Most of the major international insurance and reinsurance companies also have a presence in Russia including Aon, Marsh and Willis.

Shares of insurers owned by non-residents amounted to 16% as of end of 2013 - less than several previous years (tab.2) and below the 25% share quota allowed to non-residents at that time. At the same time four of the top ten insurers in Russia are foreign joint ventures (Reso-Garantia (AXA), VSK (via Reso-Garantia), Allianz Russia (Allianz), Renaissance Insurance). Foreign insurance brokers are not admitted with the exception of reinsurance brokers.

Table 2. Share of non-residents in shareholder capital of insurance companies

	2007	2008	2009	2010	2011	2012	2013
Share of non-residents in shareholder capital of insurance companies	9.7	13.5	16.1	22.2	17.8	17.4	15.9

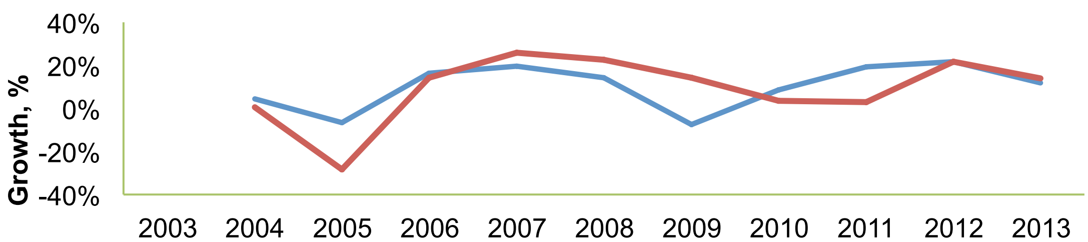
Around 65% of outwards *reinsurance* goes to foreign companies due to:

- perceived lower financial reliability of local reinsurers
- the requirement for minimum security ratings
- higher perceived country risk of doing business with Russian reinsurers
- lack of experience in certain business classes; and unwillingness to disclose business details to local reinsurers.

Industry challenges.

Insurance industry has a mixed track record in Russia. The 1990s saw a great deal of bankruptcies and fraud. Until a tightening of the tax laws in 2007, much of the subsequent activity in the industry – particularly in life insurance – was not insurance at all but rather transactions undertaken to avoid taxes and to disguise flows of money. With the tightening of the tax laws, life insurance premiums collapsed. They have since slowly begun to recover helped by the growing practice of requiring life insurance for mortgage borrowers. The negative image of insurance industry has stuck, however. Complaint levels from customers are high. The regulator even publishes list of insurer -"leader" in a number of complaints per thousand of contracts.

The business model of insurance companies is still based on cash flow underwriting and is unsustainable due to its dependency on premium growth outpacing claims growth. A downturn in premium growth triggers a liquidity crisis, making the model fail exactly when a stable insurance industry is needed most (fig.4). The main reason as seen by the All Russian Insurance Association (ARIA) lies with the lack of adequate distribution channels[1].



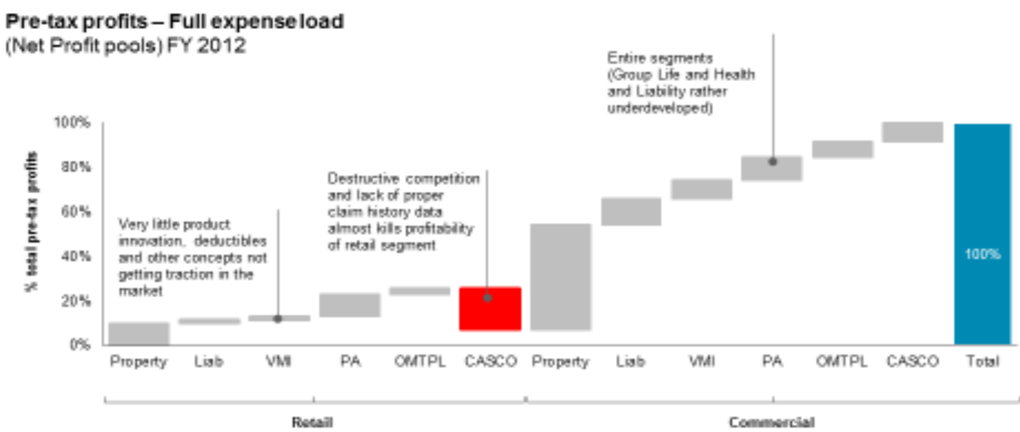
In 2013 Pay-out growth exceeded premiums growth by ~2 p.p.

Source: Oliver Wyman

Fig 4. YoY GWP (blue line) **and claims payout** (red line) **growth**

[1] According to the CBR data in 2013 direct sales accounted for 36.2%, agents share stood at 29.69%.

Independent insurance agents are used for life insurance. The sale of insurance by banks, "bankassurance", is widespread in Western Europe[1]. However, in Russia bankassurance still has a very limited penetration. Underdevelopment of distribution channels leads to misbalance between insurers and their agents and is seen by the ARIA as the main reason of low profitability of insurance companies as the lack of own distribution infrastructure allows distributors to charge extremely high commissions. The small sizes of insurance companies may also contribute to low profitability levels. According to the Russian rating agency, Raexpert the ratio of profit to net assets for 107 companies included in the ranking stood at 11% in 20132. In its turn, low profit rates do not attract investors.



Source: Oliver Wyman

Fig. 5. Product/channel premium and profit pool analysis 2012

One more feature to be mentioned – a high share of business linked to consumer credit – life insurance products are sold mainly by banks when giving consumer loans and by car sellers. Thus, when consumer credit cools as is the case now, the growth of insurance premiums also slows.

The industry suffers from a *shortage of specialized professionals* – especially in the actuarial profession, the accounting and auditing professions, and insurance law.

Hence insurance market

- Grew slower than Russia's economy, despite double digit nominal premium growth;
- Does not deliver the stabilising socioeconomic role of insurance in a modern society;

---

[1] Banks are becoming ever more important as distribution channels. According to recent estimates, around 75% of life premiums are underwritten by banks (through loans) and 17% through insurance agents.

[2] calculated as the ratio of net profit for 2013 to net assets as of end of 2013.

- Suffers from destructive competition and regulatory constraints;
- Major segments are loss making, despite being very expensive compared to other countries.

There are a number of fundamental structural attributes which drive the Russian insurance market.

Cash flow underwriting	• Cash-flow underwriting is the predominant business model • Dominates competitive behaviour and permeates operating models and strategic posture
Weak distribution footprint	• Insurers own distribution footprint/infrastructure lacks scale • Agent networks are aging and lack required sales skills • Third party distributers charge very high commissions
Lack of financial stability and control	• Little control over cash flows (branches are mini insurers) • Often undercapitalised (holes in balance sheet) • Mostly underdeveloped risk management
Inefficient back office and infrastructure	• Core insurance operations are often highly inefficient • IT mostly based on an outdated Russian accounting system 1S • Processes entangled, organisational structures overtly complex
Regulatory hurdles and weak market infrastructure	• Anti monopoly; personal data protection; paper policies, investment regime; lacking incentives for live insurance • Regulator, MinFin and Industry Association resources; lack of actuaries, surveyors and underwriters

Regulation and supervision

Licensing of insurers is carried out by segregating life insurance and non-life. However, personal insurance can be carried out by both life and non-life insurers. Composite insurers carry out personal insurance alongside their life or non-life business. Once an insurance company is licensed to carry out insurance in a respective line of insurance, the products offered in relation to that line are not subject to product approval. If an insurer wants to offer a new insurance product in the respective line of insurance that it already has a license, but with different product features, the product can be offered without further licensing. Insurers are required to report to regulator within 30 days from when a new insurance product is to be offered.

In 2013 with the organization of Mega-regulator on the base of the Bank of Russia the functions of regulation and supervision of the insurance industry passed from the Federal Service for

Financial Markets (FSFM) to the Central bank. As a matter of fact the industry has seen several models of regulation and supervision during the short time span as not long before insurance market was regulated by the Ministry of finance and before that – by specialized regulatory body.

Changes in regulatory regime in the recent years.

The investment regulation was revised in 2012 enhancing the standards for corporate stocks and bonds, permitting securities issued by international financial organizations and those listed at the world's leading stock exchanges, increasing the share of reinsurance that can be included in insurance reserves; reinsurance offered by reinsurers established in member countries of the Financial Action Task Force (FATF), Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL), OECD and World Trade Organization (WTO) was included.

A new article was added to the Accounting Law, which required all economic agents, including insurers, to establish internal control measures by January 2013. Amendments to the Insolvency law in 2012 granted greater power to the regulator to intervene in the operation of financially weak insurers. Starting with the reporting for the year 2012 financial statements using IFRS should be submitted.

Several important changes took place in 2013 when amendments to the Insurance Law were adopted and among those:

- Reinsurance was given a definition
- Some norms regulating the activities of insurance agents were introduced
- Classification of insurance activities by kind was updated
- Institute of specialized depositaries was introduced for life insurance companies
- Goals for the systems of internal control were articulated and bodies and personnel to be involved defined
- Requirements for the organization of internal audit were set
- Requirement was set to inform consumers via internet site about the company, its CEOs and shareholders, publish audited financial statements, ratings (if any), kinds and terms of insurance etc
- Requirements for the quality of capital were enhanced (own capital of insurer may not be used for loans and investments in bills unless this is consented by the supervisor)
- Limit for the aggregated share of non-residents in insurers' shareholder capital was lifted from 25 to 50 per cent.

Some improvements may come as a result of implementing of a long awaited law "On actuarial activities in the Russian Federation" adopted last year. Besides the CBR is going to create an actuarial centre of its own by the end of this year.

Russia's accession to WTO has created new commitments for market access in insurance services:

- While branching is not currently permitted by foreign insurers or reinsurers, Russia's GATS commitments envisage a phase in of branching within a nine year transition period, with additional requirements and separate capitalization
- The share of foreign capital in the insurance system is now subject to a 50 percent quota
- Life, compulsory personal insurance of passengers, and MTPL will be permitted for foreign subsidiaries to operate, five years after accession to the WTO.

Nonetheless, the industry and its regulation and supervision should be deeply modernized in order to:

- create a proper insurance market to the benefit of Russia's economy and citizens[1]
- reduce state obligations from being the insurer of the first resort to becoming the insurer of the last resort
- generate significant long term money in the economy to support domestic infrastructure projects and other investments.

To reach these goals, move to a *prudential risk-based approach to supervision* is proposed. This approach by no means may be limited to refusal from portfolio investment limits or setting several requirements the companies must meet such as capital adequacy level. It is a much more broad approach and in its context:

- The center of the supervisor's attention should be the ability of insurers to adequately access and manage the risks they face
- Goals of the supervisor should shift to evaluating business processes and risk management systems of the insurers
- The financial stability of insurers needs to be evaluated under different macroeconomic and market development scenarios
- Supervision should be based on risk assessment
- Similar to the pension market and other segments of financial markets, reforms should be undertaken both at the company level and at the regulator level
- Capacity of other market participants who are able to impact the decisions and activities of insurers may be used
- These include auditors, actuaries, investors, policyholders, rating agencies, self-regulating associations (SROs), market analysis and others

[1] "The Strategy for the development of the insurance business in the Russian Federation till 2020" adopted by the Government in 2013 sets the goal for the industry to become a strategically important sector of the Russian economy.

- The steps should be thoroughly coordinated and the measures should not be restrained to amending the legislation.

At the company level the priorities are:

- Improvement of corporate governance and internal controls systems
- Phasing out of cash-flow underwriting as a main business model
- Developing of modern products especially of funded kind and modern forms of their distribution
- Better capitalization and improvements in the capital quality (to be able to take large risks, compete with foreign insurers, to work successfully at the markets of the CIS countries).

At the regulator level the priorities are:

- Supervision of the activities of insurance companies and other institutions providing professional services to them, should become risk-based to mitigate potential risks.
- The transition from the current system of supervision to the risk-based approach would require a change in the applicable law and the restructuring of the supervisory body. The timeline must be consistent with measures to strengthen risk management in insurance companies and other institutions providing professional services to them.
- One of the important differences between the risk-based approach and the current system is that in the risk-based supervision approach, pro-active measures are widely used to prevent problems before they occur or escalate. To do this, the supervisory authority should develop adequate tools to measure the resistance of insurers to various types of risks they face, including risk assessment models. Greater monitoring for the purposes of ongoing supervision will be need. Greater offsite supervisory capacity, and monitoring discretion, would enable the supervisor to be pro-active on any issues it detects. Action related to financial stability or systemic risk should be determined to ensure clear procedures and responsibility. Improvement of IT system for regulatory reporting will be needed. At the same time insurance companies for a time being may stay within a Solvency I regime and avoid the capital burden and technical complexity associated with Solvency II internal capital modeling (see box 1).

Box 1. Risks of too quick implementation of Solvency II in the Russian life insurance industry

Today the only market players capable of implementing the regulatory requirements and taking advantage of lower capital requirements through an internal risk modelling capability will be companies with foreign capital and insurance subsidiaries of large banks. This would freeze out Russian insurers from participating in the life insurance market.

This may suggest the following longer term scenario:

- Life insurance would be dominated by banks (already the case in terms of distribution) and a few select insurers with minor share compared to the large banks o Banks will eventually hit the Basel III cliff (when the accumulated capital of their life insurance subsidiaries hits 10% of total capital, this capital has to be counted towards tier one capital of the bank, making the cost of owning the insurance operations massively more expensive and weakening the capital position of the bank)

o At this point, banks will like to sell their insurance operations (but keep the distribution). They will sell at high price, get rid of the capital in its entirety and retain the distribution, thus the risk free commissions streams. The overall impact will be a real boost on return on capital for the bank

o The likely buyers are large international insurers (probably those already having stakes in leading Russian insurers). The life market will then be owned by foreign insurers with almost now Russian capital employed in the industry

o Given the size of the balance sheets and their investment capability on infrastructure important to the Russian economy, this may not be a politically desirable outcome

Avoiding too hasty implementation of Solvency II regulation may be conducive for a faster growth of the life segment and will also help to avoid a situation of undue competitive advantage for large foreign insurers with operations in Russia.

Foreign insurers will have to reserve under Solvency II rules if their head-offices fall under Solvency II regulation which will give Russian insurers a head start from a capital perspective – compensating for weaker technical capabilities.

Box 1 reflects some of the practical concerns explaining why domestic insurance companies may have reservations against the early entry of global majors. But concerns regarding the risks of too early entry to Russian market of the big names of the global insurance business does not mean that such entry should be unwelcome in principle. It may be considered by international financial markets as an indication of strong potential and growing maturity of Russia's long-term finance. Distribution channels can be opened up by allowing foreign life insurance companies, that have been successful in other markets, to replicate elements of their infrastructure in Russia.

For instance, Prudential plc is currently not operating in Russia. However, it has valuable experience of working in emerging markets, particularly in Asia. It is a leading provider of health and protection insurance products to the emerging middle-class families in some rapidly growing countries. The company uses a number of distribution channels such as bancassurance with a number of global partners (e.g. Standard Chartered Bank, Citigroup) and local (e.g. ACLEDA, Thanachart) to employing an approximately 400,000 strong agency workforce across the region. It has also led the way in helping governments to set up the regulatory framework in some of the markets (e.g. Indonesia and Vietnam). Presence of Lloyd's at the Russian market could give a positive signal to other international insurers but widening of its activities here could require special arrangements and exemptions from the Russian legislation due to unique status of Lloyds.

In the longer run these considerations prompt the removal of *FDI restrictions.* However, in the short to medium term exiting FDI restrictions are not binding because the actual FDI level is far bellow the set limit of 50%.

Another facilitating option for FDI will be to allow *to deal under English/NY law.* But this option should be carefully evaluated in the context of the Russian legal system and the difficulties of granting exemptions form the Russian law for just one particular industry.

Taking into account the reputation of the insurance market, better protection of rights of policyholders is of crucial importance. It includes compensation mechanisms in the event of an insurer's bankruptcy and establishment of a formal ombudsman process, which would offer economically weaker policyholders a practical mechanism for redress. A bill establishing a financial ombudsman with enforceable decision-making powers has been submitted to The State Duma this spring. The Government program "The Development of Financial and Insurance Markets, Creating of International Financial Centre" adopted in 2013 calls for the establishment of a safety net to ensure the execution of liabilities by insurers. But its design is yet to be worked out.

Improvements in the regulation of retail insurance products and their distribution are also needed, including unification of terminology used and standardization of retail insurance products. At the same time, consumers and lawmakers should understand that funded insurance is a part of financial market and market risks are immanent to products of this kind. Stimulating provision of modern insurance products may require greater flexibility in determining of the insurance sum, approval of wider range of investment instruments and techniques, including the use of derivatives. Some legal restrictions should be mitigated, for example, requirement that the insurance sum is defined in the contract impedes development of variable annuities and with profit products such as unit linked policies or provoke insurers to take excessive risks providing guaranties.

To promote conditions for the industry to play a significant role at financial markets, terms of business for funded life insurers should be leveled not only with NPFs but also with mutual funds. It may be easier to achieve this under mega-regulator. However, equal access should not be reached at the cost of safety of investors or transparency of products or higher expenses.

Accounting rules for funded products should be changed - insurer liabilities before such clients should be separated from other liabilities and own funds of the insurer, they should be invested separately, and investment returns should not be taxed as a company profit. Tax regime for such products should be brought close to that of mutual funds (PIFs).

On a policy maker level the following objectives need to be translated into specific actions which are then transferred into a roadmap that all stakeholders commit to:

- **Phase out of cash-flow underwriting as a viable business model.**
- **Establish stringent financial transparency and control:** Introduction of IFRS accounting a strict control of type and quality of assets on the balance sheet will get a long way to phasing out cash-flow underwriting. Higher frequency of reporting and more granularity of reported numbers should also be considered.
- **Re-balance the power between insurers and distributers:** The lack of own distribution infrastructure allows distributors to charge extremely high commissions. Regulation needs to establishing a more balanced power structure between insurers and distributers and encourage the build-up of owned distribution capabilities.
- **Repair the dysfunctional economics of the motor segment:** Today customers pay Casco premiums about 3 times larger than the European average, acquisition cost are about 5 times higher than in Europe and insurers are still making a significant underwriting loss. The value is captured by distributers and the customer pays the bill. Osago is a disaster, with some regions having up to 60% of claims resolved in courts pushing the entire segment to significant losses for insurers (some are considering returning their licenses).

- **Digitalize all transactions related to simple insurance products.**
- **Remove regulatory hurdles:** Reduce number of licenses to licensing for product classes and not individual products and other potentially competition distorting requirements.
- **Standardize insurance terminology and establish industry wide databases:** moving to standardized terminology in insurance contracts will greatly improve transparency and reduce legal cost in cost cases. Establishing industry wide claims data (for example in motor) and making them evaluable for insurers will greatly improve pricing capabilities and create fairness for customers. The lack of standardized terminology in laws and insurance contracts creates significant grey space and is the source of courts overloaded with insurance related cases.
- **Unlock the Life and Savings segment:** Unlocking the life/savings segment will require tax incentives for long term savings products with guarantees. Regulation needs to ensure that the tax benefit is retained in the policy and not traded away to distributors and that reserves are managed adequately within a prudently chosen investment regime. In addition, insures may be allowed to take a role in the pension and collective investment industries.
- **Prepare the insurance industry to take a significant role as underwriters in OMI:** The aspiration under discussion is to move to a health system similar to a Netherlands' type model. Whilst it is impossible to define the role of insurance in the health care provision in detail before a decision on the future health system has been made, many steps are obvious and can be prepared now
- **Introduction of prudential approach:** Once balance sheets have been stabilized and the transition from cash flow to reserve model has been made, and a strong, functionally capable, self-regulated insurance association has been established, prudential approach may be introduced.
- **Establish a framework for mandatory insurance:** Rather than deciding at hoc (after disastrous events) on implementing new types of mandatory insurance, a framework should be set up to facilitate an unemotional discussion on the role of the State in providing risk protection and the potential mandation of insurance.
- **Strengthen the domestic reinsurance industry:** Today domestic reinsurance capacity is small and weakly rated. To fulfill its role as reinsurer for smaller companies and specific types of risk which international reinsurance markets have not appetite for, it is important to strengthen the domestic reinsurers.
- **Protect customers and create stability and trust.**
- **Engage in a path of regulatory convergence:** WTO, Solvency II, Consumer protection, and other international regulatory regimes provide reference points for next stage regulatory development. New regulation should not conflict with eventual convergence.