

Unity Re

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Unity Re

Major Rating Factors

Strengths:

- Improving competitive position.
- Good level of capitalization.
- Good results from insurance operations.
- Good quality of investment portfolio instruments.

Weaknesses:

- High industry and country risk.
- Small size and limited franchise.
- Volatile concentrations and high currency risk in the investment portfolio.

Operating Company Covered By This Report

Financial Strength Rating

Local Currency

BB-/Positive/--

Rationale

The ratings on Russia-based reinsurer Unity Re reflect its improving competitive position, good capitalization, and good results from the insurance business. In Standard & Poor's Ratings Services' view, Unity Re also benefits from a good quality investment portfolio. However, the high industry risk of operating in the Russian Federation (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2; Russia national scale 'ruAAA'), combined with Unity Re's small size and still limited franchise, acts to offset these positive factors, as do the volatile concentrations and high currency risk in the company's investment portfolio.

Unity Re is a small but stably growing reinsurer based in Moscow, with gross premiums income of Russian ruble (RUB) 897.5 million (about \$28.9 million) in 2009 (RUB842.5 million in 2008). The company operates primarily in Russia and the Commonwealth of Independent States (CIS), where it derived 95% of its gross premiums income in 2009. We regard Unity Re as having a fairly wide and loyal customer base among Russian insurance companies. In our view, its position is bolstered by its adequate reinsurance protection, high level of customer service, and brand recognition. Moreover, the company enjoys relationships with almost all the top Russian direct insurance companies and major players in the broker market. The company also benefits from the implicit support of the affiliated Russia-based insurance company RESO-Garantia (not rated) and the wider RESO Group, which is a large holding company with assets related to insurance, medical services, leasing, development, and asset management in Russia and other CIS countries.

Based on gross premiums written (GPW) in 2009, Unity Re ranks third among specialist Russian reinsurers and in the top 10 of all companies in Russia that write reinsurance. However, Unity Re's reinsurance market share remains only modest at about 4%, compared with 2.5% in 2008; although we view this as typical for specialist reinsurers in Russia.

Unity Re's capitalization is good, in our view. The company benefits from very strong capital adequacy (according to our risk-based model), adequate reserving, and good reinsurance protection. However, its total risk-adjusted capital base of RUB605 million, as of Dec. 31, 2009, is modest in absolute terms. As a result, we think that its capitalization parameters remain extremely sensitive to volatile levels of concentration in the investment portfolio.

Unity Re's total investment portfolio is limited in size, which has led to quite volatile single-name concentrations, an unhedged open currency position, and significant exposure to the Russian bond market. In May 2010, 90% of the company's total investments were bonds: about 43% of total investments were bonds of foreign issuers with strong credit quality and the remainder was made up of bonds issued by Russian corporates. We believe that increased exposure to the Russian bond market creates certain risks because of the large volume of observed defaults, a record of low recovery, and the market's volatile liquidity.

About 70% of Unity Re's total assets are denominated in U.S. dollars or euros. The company has a long position, in terms of its foreign currency exposure, equivalent to about 110% of its capital base. We believe that such an exposure carries high risk, especially considering the historic volatility of the Russian ruble exchange rate.

Outlook

The positive outlook reflects our expectation that Unity Re will further enhance its competitive position through sustainable growth in both premiums and number of risks, which is likely to lead to greater portfolio diversification. In addition, we expect the company to maintain a sound operating performance and very strong risk-based capital adequacy that reflects its moderate risk appetite.

We could consider a positive rating action if Unity Re further strengthens its competitive advantages while achieving profitable growth and maintains very strong risk-based capital adequacy and a good quality investment portfolio.

We might revise the outlook to stable if the company's competitive advantages, earnings, capitalization, or investment-portfolio quality were to deteriorate.

Corporate Profile: Small But Expanding Regional Reinsurer

Unity Re is a reinsurer based in Moscow, with gross premiums income of RUB897.5 million in 2009 (RUB842.5 million in 2008). The company operates primarily in Russia, where it generated 62% of gross premium income in 2009 (91% in 2008). Premium income from Russia and the rest of the CIS combined made up 95% of Unity Re's GPW in 2009, and exposure to overseas markets is consequently minor. Unity Re offers treaty and facultative reinsurance on both a proportional and nonproportional basis, with facultative business accounting for 75% of the book of business in 2009 (60% in 2008).

The company's product range includes property and engineering business at 55% of GPW in 2009 (55% in 2008), motor own damage 21% (26% in 2008), marine hull and cargo 7% (12% in 2008), liability 15% (minimal in 2008), and other 2% (7% in 2008). In addition, it specializes in large industrial, energy, and commercial risks.

Although Unity Re's corporate history dates back to 1991, the current structure was adopted in 2004 when it became the reinsurance company RESO-Re. RESO-Re was subsequently rebranded as Unity Re in September 2006. Since becoming active in 2004, Unity Re has been a 100% subsidiary of RESO-Garantia, a top-three retail insurer in Russia.

In June 2008, there was a change in the shareholder structure, which turned Unity Re from a RESO-Garantia subsidiary into a sister company. Ownership was transferred to the wider RESO Group, which operates on a disintegrated basis, with most companies having their own management teams. The ultimate shareholders of RESO

Group are private individuals.

We understand that Unity Re is considering the sale of a minority stake to a large international investor. However, the company has not yet decided on the timing or the size of the sale. We do not envisage any rating upside over the short term if this deal is completed, but we would expect Unity Re's corporate and governance procedures to improve as a result.

Competitive Position: Improving, But High Industry Risk Remains

Table 1

Unity Re--Business Statistics	IFRS			Russian GAAP	
	2009A	2008A	2007A	2006A	2005A
(Mil. RUB)					
Gross premiums written	897.5	842.5	316.3	350.4	245.0
Annual change in gross premiums written (%)	6.5	166.4	0.0	43.0	404.8
Net premiums written	556.7	803.4	304.6	345.8	60.0
Annual change in net premiums written (%)	(30.7)	163.8	0.0	476.4	59.4
Net premiums earned	503.9	774.9	430.2	136.6	49.2
Net investment income	66.9	137.3	89.2	20.8	28.8
Taxation	(37.9)	(18.4)	(41.5)	(8.4)	(7.7)
Retained earnings less dividends for distribution and other reserves movement	150.7	56.5	121.6	25.3	24.9

RUB--Russian ruble.

We view Unity Re's overall competitive position as marginal, reflecting the company's improving competitive advantages and high industry risk in Russia. Unity Re's competitive position is supported by a relatively wide and loyal customer base among Russian insurance companies, adequate retrocession capacity, a high level of customer service, and a well-known brand, the latter of which is helped by its relationship with RESO-Garantia.

In 2009, Unity Re's GPW increased by 6.5% year on year. This growth came despite the nonrenewal of a large single contract with one cedant (a company that places reinsurance business with Unity Re) for a total of about RUB300 million in 2008. We note, however, that part of the year-on-year growth is attributable to fronting deals.

Unity Re's market-oriented portfolio managed to show marginal growth in 2009, despite unfavorable market conditions and an overall contraction in the reinsurance market.

Based on results for the first half of 2010, GPW further increased to RUB594 million compared with RUB465 million for the corresponding period in 2009: An increase of 28% that was better than our estimate for reinsurance market growth during the same period. At the same time, the amount of claims decreased to RUB169 million, compared with RUB187 million in the first half of 2009.

Unity Re ranks third among specialist Russian reinsurers and in the top 10 of all companies in Russia writing reinsurance, in terms of GPW. Unity Re's reinsurance market share remains only modest, at about 4% compared with 2.5% in 2008. However, we view this as typical of specialist reinsurers in Russia.

Unity Re has adequate distribution channels, in our view, and these are dominated by direct reinsurance business. As of Dec. 31, 2009, 80% of its business came directly from insurers and 20% from brokers. We understand that Unity

Re is working on increasing the share of broker-related business. In 2009, Unity Re had an extremely high renewal ratio of about 87%.

In 2008–2010, Unity Re managed to penetrate the top layers of the obligatory reinsurance market for many insurers in Russia and other parts of the CIS. Previously, Unity Re had accessed only the lower layers, which produced higher premiums, but were subject to increased volatility and losses. We see this expansion as positive and believe it shows the market's increasing confidence in Unity Re, higher brand awareness, and a further diversification of the company's portfolio.

Unity Re has managed to establish partnerships with almost 350 cedants and brokers--mainly in Russia and the rest of the CIS--including the largest Russian insurers. Unity Re is included in the security lists of most Russian brokers and many international brokers who work within Russia and the rest of the CIS, which we view positively.

We expect Unity Re's premiums to continue to increase in 2010. We believe that Unity Re's business will expand over the medium term, fueled by its competitive advantages. We think this trend could be underpinned by a reduction in the number of Russian reinsurers; the relative resilience of the reinsurance segment to wider industry turbulence; increasing demand for additional domestic capacity; and new obligatory insurance for dangerous objects (to be introduced in 2013), which would require significant reinsurance capacity in Russia.

Management And Corporate Strategy: Growth Through An Increased Number Of Risks

We view positively Unity Re's corporate strategy of expanding organically and increasing its market share by focusing on inward reinsurance and diversifying its portfolios in terms of clients and geography. We understand that the company is aiming to achieve growth through increasing the number of risks, but not retention levels. The company expects this growth to come mostly from existing clients.

Despite several years of year-on-year growth, Unity Re has, in our view, managed to preserve the level of its services and promote a very proactive and client-oriented approach. In the future, the company plans to further exploit its market expertise and corporate relationships to meet its high growth objectives, which are likely to be backed by strong capital adequacy and good reinsurance protection.

We also view positively Unity Re's plans to achieve a loss ratio of about 60%, a combined (loss and expense) ratio of 80%-90%, and to keep its administrative costs at the currently low levels. At the same time, we anticipate that further growth may create a need for additional staffing.

Unity Re's plans include a further strengthening of its market position through geographic expansion in the CIS, particularly in Kazakhstan (BBB-/Stable/A-3) and Ukraine (B+/Stable/B). Over the medium term, we understand that Unity Re would like about 10% of its portfolio to comprise risk from outside the CIS.

In our view, Unity Re's management is stable and experienced, but with only 20 staff it depends heavily on a small team.

Enterprise Risk Management: Weak, Given The Size Of The Management Team

Unity Re has adequate risk controls, in our view. However, we regard the company's overall enterprise risk management as constrained by the small size of its management team and, consequently, we view it as weak. Although Unity Re has identified the main risks to which it is exposed and monitors them continually, it has a very limited risk-management structure that depends heavily on a small team, and the risk-control roles are mostly assumed by risk takers and senior management.

We believe that Unity Re's risk management will require significant improvement if it is to expand as planned over the next two to three years. Although no formal governance structure is in place, we believe that risk awareness is nevertheless well engrained in the company. At present, we view Unity Re's risk models as unsophisticated, and economic capital modeling does not form part of its risk-management systems.

Accounting: IFRS Compliant Since 2008

Unity Re has historically reported under Russian generally accepted accounting principles (GAAP), and since 2008 has done so using International Financial Reporting Standards (IFRS).

For our analysis, we have used preliminary statutory accounting data for the first six months of 2010, and IFRS data for 2009, 2008, and 2007. KPMG audited the IFRS accounts. In addition, we used unaudited management financial reports for the first half of 2010; we have not made any significant adjustments to these figures.

Operating Performance: Still Volatile, Despite Recurring Profits

Table 2

Unity Re--Consolidated Operating Statistics					
(Mil. RUB)	IFRS			Russian GAAP	
	2009A	2008A	2007A	2006A	2005A
Gross loss ratio (%)	53.4	39.6	67.3	82.9	15.5
Gross combined ratio (%)	70.1	71.3	82.2	106.6	19.9
Net loss ratio (%)	68.6	40.4	67.4	62.4	76.0
Net expense ratio (%)	23.5	32.6	15.2	24.7	26.0
Net combined ratio (%)	92.2	73.1	82.6	87.1	102.0
ROE (reported equity) (%)	26.9	11.2	51.1	7.1	7.5
Return on revenues (%)	15.8	29.9	18.8	12.9	39.2

RUB--Russian ruble.

We consider Unity Re's operating performance to be marginal. We see the company's recurring profits over the past four years as a positive sign, but they remain volatile, reflecting a limited portfolio with a concentration of large accounts.

In 2009, Unity Re produced strong underwriting results, reflected in a net combined ratio of 90.6% (73.1% in 2008). Operating results were underpinned by a low net-loss ratio of 68.6% in 2009 (40.4% in 2008). The return on equity peaked at 28.3% in 2009 (11.2% in 2008), mostly because of investment-portfolio profits. A year-on-year

increase in the company's combined ratio resulted from the nonrenewal of a large single contract with a cedant, which was, however, very profitable in 2008, and lower profits across all lines.

In 2010, we expect Unity Re's net combined ratio to remain less than 90% and improve slightly compared with 2009. This is likely to follow the growth and increased diversity of Unity Re's business book. We expect the insurance result to largely determine the company's bottom line in 2010. This is because investment results are likely to weaken, owing to the nonrecurring nature of profits from the sale of its equity portfolio in 2009, a switch to more conservative bonds and deposits, and an overall decline in interest rates in Russia. Nevertheless, we still expect Unity Re's return on equity to be high.

Investments: Increased Exposure To Russian Corporate Bonds And High Currency Risk

Table 3

(Mil. RUB)	IFRS			Russian GAAP	
	2009A	2008A	2007A	2006A	2005A
	Total investments	1,025.6	875.0	840.7	478.1
Bonds and other fixed-interest securities (%)	34.3	37.6	24.9	10.2	0.0
Equities and other variable-interest securities (%)	0.0	5.2	34.3	0.0	0.0
Property (%)	0.00	0.00	0.00	0.00	0.00
Cash and bank deposits (%)	65.1	56.3	39.6	88.8	91.5
Other investments (%)	0.59	0.94	1.23	0.94	0.94
Total investment return (incl. unrealized and realized) (%)	17.5	(15.6)	0.0	4.8	9.4

RUB--Russian ruble.

We view Unity Re's investments as marginal overall, reflecting quite volatile single-name concentrations, an unhedged open currency position, and significant exposure to the Russian bond market. In 2010, Unity Re changed its investment strategy, increasing its focus on bonds. The company aims to strike a balance of 70% and 30% for bonds and bank deposits, respectively. As of Dec. 31, 2009, the bank portfolio was about 65%, but by May 2010 the composition was quite different, with 90% of the portfolio invested in bonds. About 43% of total investments were bonds of foreign issuers of strong credit quality and the remainder were bonds issued by Russian corporates. Consequently, exposure to Russian banks has declined to 10% of invested assets. Unity Re abandoned its investments in equities after a portfolio sale in 2009.

We expect certain risks to result from increased exposure to the Russian bond market, mainly because of the large volume of observed defaults, a record of low recovery, and the market's volatile liquidity. We also see an element of operational risk because the bond portfolio is managed by AMK Finance (not rated), an asset-management company belonging to the RESO Group.

In May 2010, Unity Re had a moderately concentrated investment portfolio. However, this represented an improvement from year-end 2009, when its portfolio was extremely concentrated and almost 55% of the investments were deposits with two Russian banks. Although we acknowledge that this concentration was temporary, we believe it could recur and limit Unity Re's asset-management capabilities in the future. Moreover, we believe that Unity Re's investment policy is subject to swings in shareholder preferences.

Almost 70% of Unity Re's total assets are denominated in U.S. dollars or euros, while a larger part of its liabilities are in rubles. This mismatch reflects a shareholder decision to hold capital in foreign currencies. In our view, this mismatch could be very risky, especially considering the historic volatility of the ruble exchange rate. We view as positive the fact that Unity Re has a policy of monitoring its foreign-exchange investment exposure daily. These positions are also reviewed at the RESO Group level.

Liquidity: Strengthened By Positive Cash Flows

We consider Unity Re's liquidity to be good. Although we view the company's investments as strengthening its liquidity position, we note that the liquidity of Russian corporate bonds can be quite volatile. Unity Re has historically recorded positive cash flows, and we believe that its operating cash flow will stay positive through 2010 and beyond.

Capitalization: Good, With Very Strong Capital Adequacy

In our view, Unity Re's capitalization is good, with very strong capital adequacy (as measured by our risk-based model), adequate reserving, and good reinsurance protection. However, the company's total risk-adjusted capital base of RUB605 million, as of Dec. 31, 2009, is modest in absolute terms.

Capitalization parameters remain extremely sensitive to changing concentrations in Unity Re's investment portfolio. In addition, an open currency position is currently having a negative effect on capitalization. However, we consider it likely that capitalization will remain stable over the medium term, especially in light of the company's continuous profit retention.

Reserves: Adequate, although business is mainly short-tail

Unity Re writes predominantly short-tail business, and we do not consider reserving to be a major rating factor. Overall, we think that Unity Re's reserves appear adequate. The company uses traditional actuarial techniques to calculate the level of its reserves. In 2009, KPMG audited its reserves and reported no issues.

Retrocession: Good quality reinsurance protection

Historically, Unity Re has used very little retrocession (placed risk with other reinsurers). In 2009, the level of premiums it placed increased to RUB340 million from RUB39 million in 2008. Most of the increase (RUB290 million) related to fronting business provided by Unity Re for a number of Kazakhstan-based companies. Despite the reported increase, there was no significant change in the company's reinsurance policy. We regard the current reinsurance protection as good.

The quality of Unity Re's property and engineering excess-of-loss treaty is good, in our opinion. During the last renewal period in July 2010, the limit was raised to \$49 million in excess of \$1 million, from the previous \$29 million. The lead reinsurance program is a major international company of high financial strength. The other reinsurers include a small number of unrated companies.

Since July 2010, Unity Re's marine hull and cargo program has provided cover for \$6.5 million in excess of \$0.5 million. The marine hull and cargo program is led by a member of the Lloyd's syndicate. Less than 3% of the program is placed with unrated reinsurers. Unity Re does not write catastrophe reinsurance and has limited exposure to risk accumulation, which is monitored by the company's board. Unity Re calculates its probable

maximum loss exposure (estimated to be \$4 million from the marine hull portfolio), which we consider adequate relative to the company's current capitalization and reinsurance protection.

Financial Flexibility: Reliant On Shareholder Support

Table 4

Unity Re--Consolidated Capitalization Statistics					
(Mil. RUB)	IFRS			Russian GAAP	
	2009A	2008A	2007A	2006A	2005A
Total adjusted equity	587.8	532.7	476.2	371.3	346.7
Change in adjusted equity (%)	0.1	11.9	0.0	7.1	8.7
Reinsurance utilisation ratio (%)	38.0	4.6	3.7	1.3	75.5
Net unearned premium reserves/net premiums earned (%)	43.0	18.8	0.0	159.4	65.9
Net technical reserves/gross technical reserves (%)	74.9	94.7	97.8	92.4	96.6
Net technical reserves/net premiums written (%)	104.7	60.7	131.3	95.1	123.0

RUB--Russian ruble.

Unity Re's financial flexibility is marginal, in our view, but it is supported by the close interest of the holding company, RESO Group. We consider the shareholders' zero-dividend policy to be a demonstration of their commitment to the company's growth and development.

We view favorably the shareholders' decision to increase the statutory capital of Unity Re to RUB500 million via the capitalization of retained profits. It demonstrates, in our opinion, the shareholders' commitment to reducing the amount of funds available for distribution via dividends. It is particularly important with regard to the minimum regulatory capital for all Russia-based reinsurance companies, which will be RUB480 million starting from Jan. 1, 2012.

The shareholders' ability to provide capital support in times of financial difficulties is high, considering the relative size of the shareholder group, but so far this ability remains untested.

The appearance of a minority international investor is not likely to change our view on financial flexibility.

Ratings Detail (As Of August 23, 2010)*

Operating Company Covered By This Report

Unity Re

Financial Strength Rating

Local Currency

BB-/Positive/--

Counterparty Credit Rating

Local Currency

BB-/Positive/--

Russia National Scale Rating

ruAA-/--/--

Domicile

Russia

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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