

# For Taiwan Life Insurers, Reduced Hedging Could Amplify Forex Risk

May 3, 2022

## Key Takeaways

- Higher U.S. interest rates and a stronger greenback over 2022-2023 are likely to complicate Taiwan life insurers' strategy of relying heavily on foreign-currency investments for yield.
- The rising cost of hedging instruments makes it more difficult for insurers to maintain the profit level they would typically expect from their foreign currency-denominated holdings, despite the likely strength of the U.S. dollar over the next few quarters.
- Over the next one to two years, the sector's exposure to foreign-exchange risk will remain at an historical high, adding capital risks for most of the life insurers. Those risks remain manageable for the sector as a whole, but some insurers with a slim capital buffer could come under pressure.
- We believe prudent and effective hedging is a critical component of insurers' current investment strategy. Over-emphasis on short-term profits when managing insurers' long-term exposure could amplify foreign exchange-related risk.

Incremental interest rate rises typically improve the portfolio returns of life insurers, due to their sizable holdings of interest-yielding securities. However, in Taiwan the calculation is not so simple. For that reason, S&P Global Ratings believes that foreign exchange (forex) related hedging will remain a necessary and ongoing cost for this segment.

The investment strategy of these insurers has created a currency mismatch. In this case, the mismatch broadly equals foreign-currency denominated portfolio investment assets minus the natural hedge provided by foreign currency-denominated insurance policies.

We expect U.S. rates to rise over the next few quarters, and at a faster pace than Taiwan's tightening. At first glance this seems like a positive. But for Taiwan's life insurers the scenario would increase the cost of their hedging tools despite the return on new foreign currency investments could rise. That's because the differential between interest rates in the U.S. and Taiwan is a reference point for the price of conventional forex hedging tools such as currency swaps.

The insurers hold a high proportion of foreign currency-denominated investments in their portfolios, at more than 60% of invested asset classes. But their insurance policy liabilities remain largely in local currency. Forex-related hedging is therefore not simply a short-term cost.

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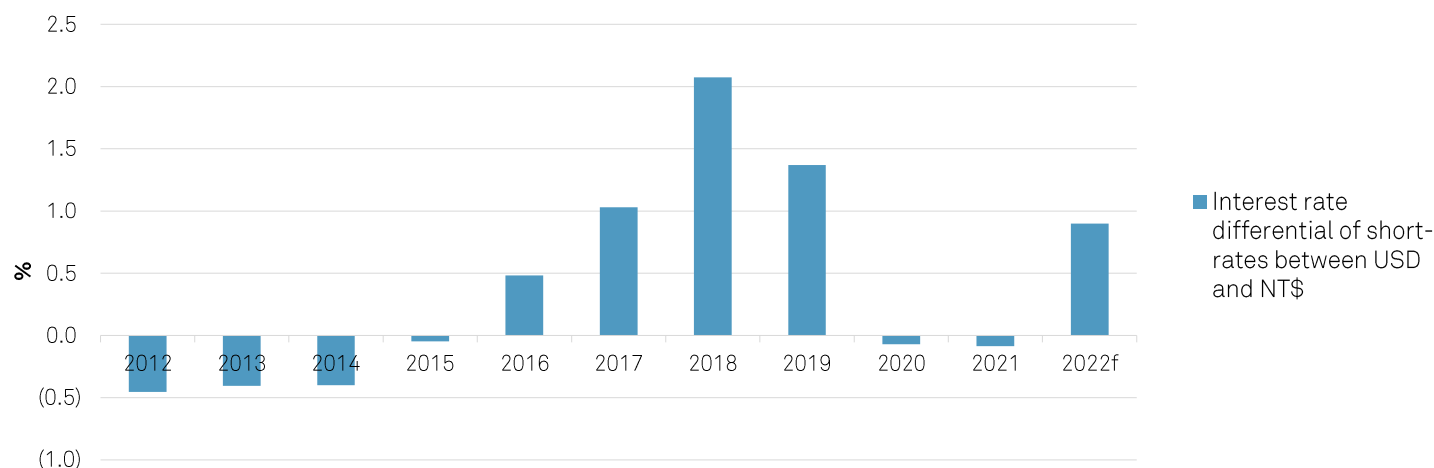
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## Heavily Allocated Foreign Currency Investment Brings Challenges

In our view, the interest rate differential between the short-term rates in the U.S. and Taiwan will widen over the next few quarters. As a result, we expect the U.S. dollar to appreciate against the new Taiwan dollar (NT\$) throughout 2022 (see chart 1).

Chart 1

### Hedging Costs May Rise On Rising U.S. Rates



f--Forecast. Short rates: yield to maturity of generic on-the-run 3-month government bills/notes for the country shown measured at the end of each period. Source: S&P Global Economics, Oxford Economics.

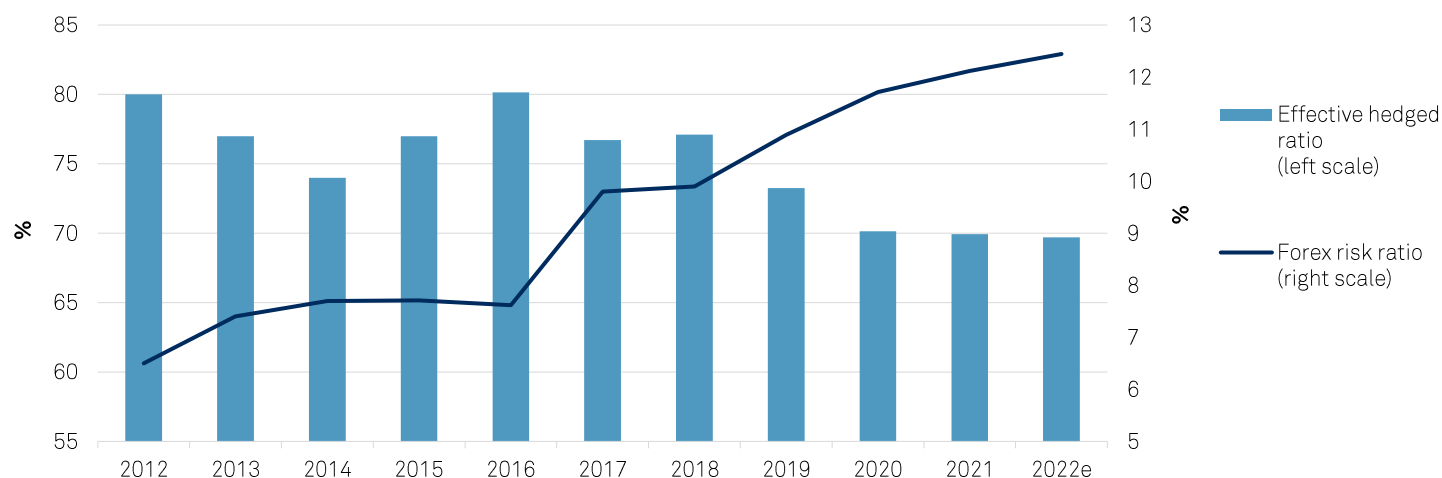
On one hand, therefore, insurers may face rising hedging costs for currency swaps, which are typically priced by reference to the interest rate differential.

On the other hand, the insurers believe they have the opportunity to reduce their hedged position in the expectation of U.S. dollar appreciation, despite the need to meet regulatory capital requirements. A lower hedged position could lead to regulatory demand for higher capital provisioning.

Over the next six to 12 months, we predict the forex risk exposure of Taiwan's life insurance industry will increase slightly, in line with our expectation that its hedged position will edge down. Over the past decade, we have seen a twofold increase in forex risk exposure in the sector (see chart 2).

Chart 2

### Forex Risk Ratio Will Remain At A Historic High



e--Estimate. Source: S&P Global Ratings, Taiwan Ratings estimates.

The forex risk ratio measures the level of forex risk that the sector is exposed to relative to total balance sheet assets, taking into account the offsetting effect of an insurer's forex volatility reserve. Taiwan life insurance companies are required to have foreign exchange volatility reserves set aside to cushion potential currency revaluation losses from their large holdings of foreign currency-denominated assets.

The effective hedged ratio measures how much the insurers have effectively hedged their currency mismatched exposure by using hedging tools, which include both conventional and non-conventional tools.

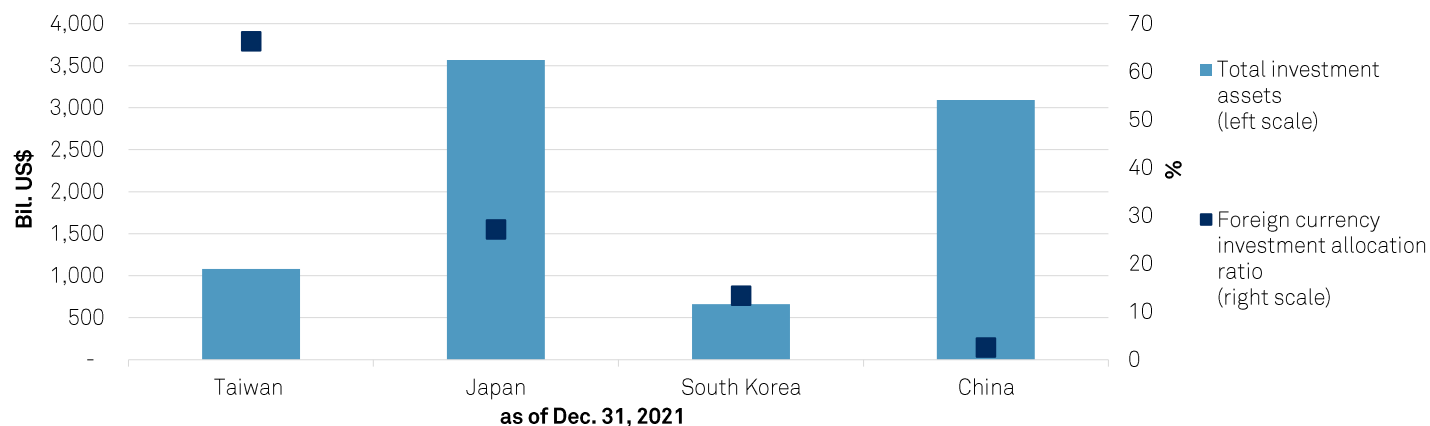
Current conditions illustrate that balancing the risk and reward of foreign currency-denominated investments while maintaining a stable credit profile is not always straightforward.

### Taiwan Insurers Have The Region's Highest Foreign Currency Allocation

The sector has the highest investment allocation in foreign currency among its major peer groups (see chart 3), and it is at a moderately high level of industry risk. In our view, the sector's high currency mismatch exposure may cause profit volatilities due to both the considerable cost of hedging tools and the risks from unhedged forex positions.

Chart 3

### Taiwan Life Insurance Sector Has Above Average Foreign Currency Risks: Regional Comparison



Source: S&P Global Ratings. Insurance Institute of Taiwan, The Life Insurance Association of Japan. Korea Life Insurance Association. Ratio over total investment assets.

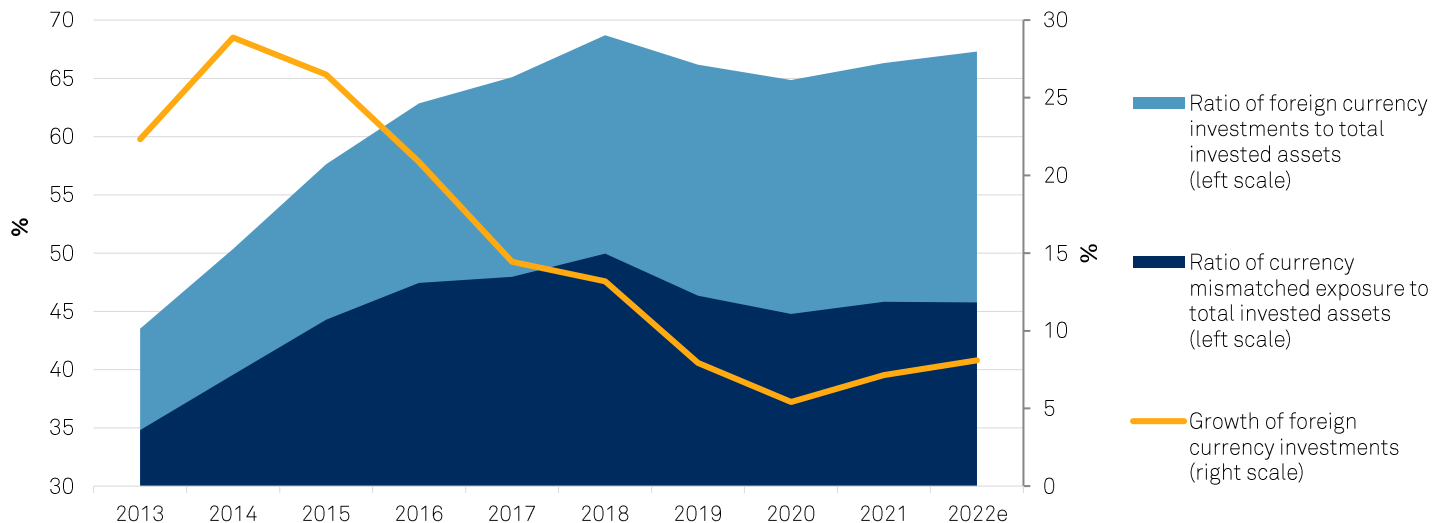
Insufficient supply of long-dated investment instruments in Taiwan's local currency, which would match the long duration of insurers' liabilities, has motivated life insurers to invest heavily in foreign-currency assets.

The foreign currency investment allocation ratio increased in 2021, following a two-year decline on the back of tightened regulatory rules over foreign currency investments. We estimate the investment allocation ratio is likely to continue to increase to around 67% in 2022, from 66% in 2021.

The growth in foreign-currency investments is based on our expectation of strong sales of foreign-currency insurance policies. That is in contrast to the sector's overall business growth, which will likely remain muted as a result of regulatory-driven reform of premium policies in Taiwan. We estimate the sector will maintain overall forex mismatched exposure at around 45% of total invested assets during 2022 (see chart 4). That's because most of the new foreign-currency investments will be backed by foreign-currency policies, which do not create additional currency mismatch risks.

Chart 4

### Growing Foreign Currency Insurance Helps Moderate Some Forex Risks



e-- Estimate. Source: Insurance Institute of Taiwan, S&P Global Ratings, Taiwan Ratings estimates.

### Hedging Forex Risk Is A Necessary Cost

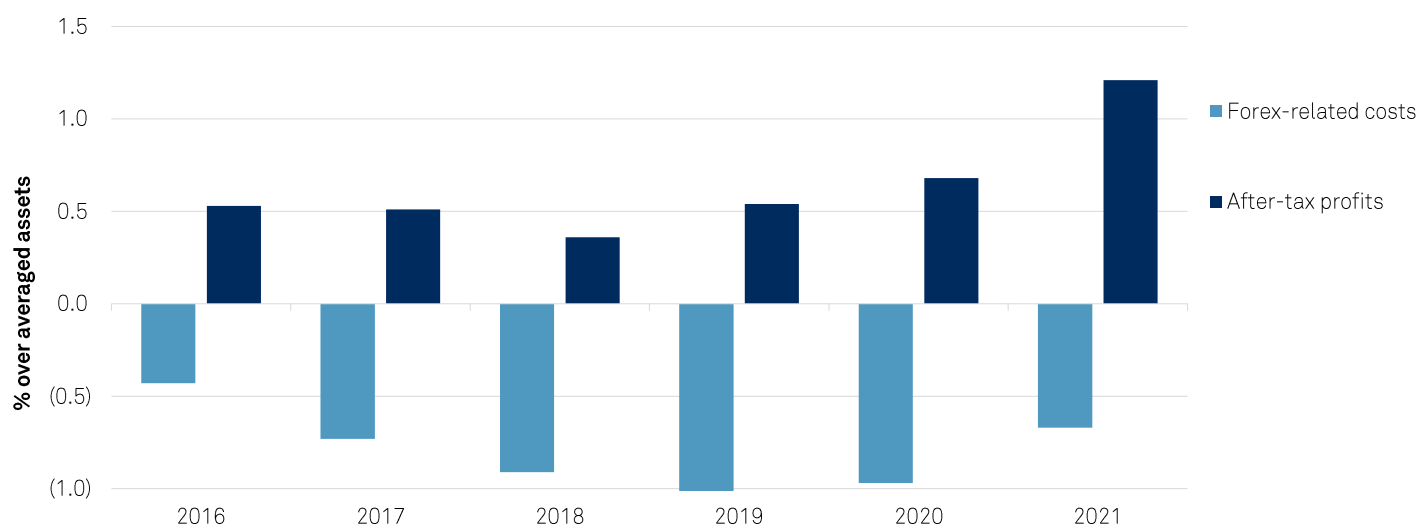
We view the sector's forex risk as a long-term exposure, rather than a short-term, transactional one. In our view, forex-related costs, including hedging costs, are not simply a short-term earnings shock for the insurers to manage.

Around 80% of the sector's foreign currency-denominated investments are in the form of long-term fixed income securities. The insurers typically arrange onshore conventional hedging tools at the initial placement of foreign-currency investments. For that portion of the foreign currency-denominated portfolio that has grown due to capital growth or interest yield, insurers might arrange offshore hedging instruments such as non-deliverable forward instruments, or non-conventional hedging (e.g. basket hedging). Or, they might opt to leave the holdings unhedged. Insurers might also consider setting aside some of the earnings to increase the provisioning of their forex volatility reserves in order to offset some of the earnings impact from forex risks.

All the above come with costs. The combination of these is known as the sector's total forex-related costs. These represent a considerable portion of the insurers' earnings structure (see chart 5). We estimate the extent of forex-related costs compared with average assets is likely to increase during 2022-2023, as the U.S. dollar appreciates. The total forex-related costs accounted for around 0.7% of average assets in 2021. This level dropped from nearly 1.1% in 2019, partly due to reduced prices for currency swaps.

Chart 5

### Forex-related Costs Are Part of Insurers' Cost of Living

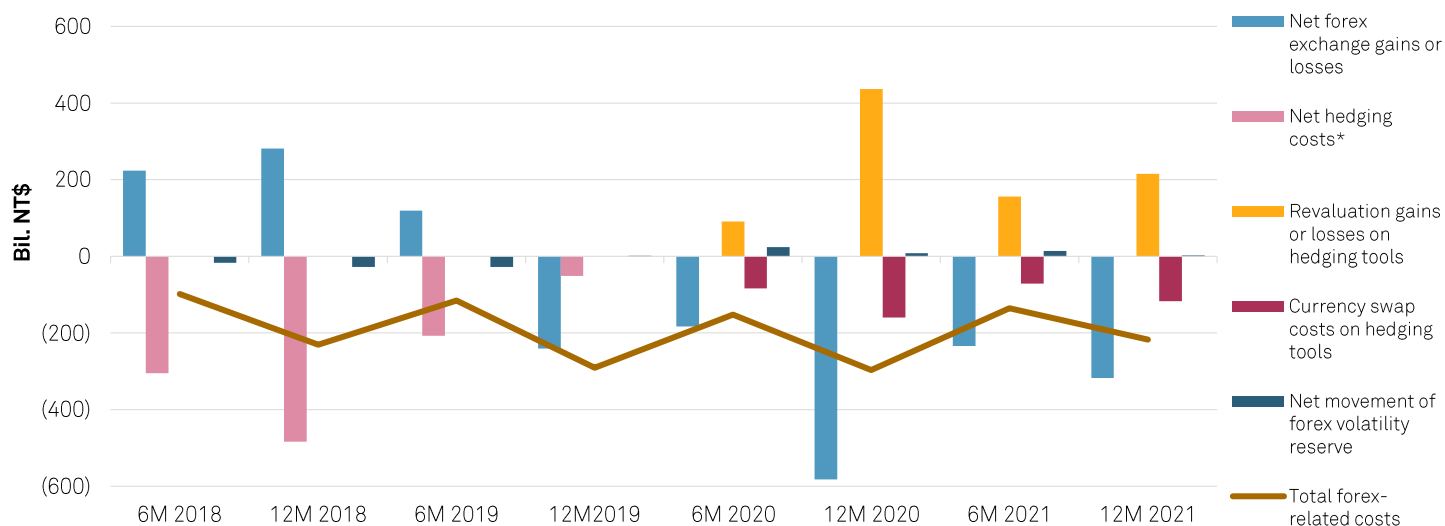


Source: Taiwan Insurance Institute. Financial Supervisory Commission of Taiwan, S&P Global Ratings, Taiwan Ratings.

The insurers reduced their hedged position in 2020 and it remained level in 2021. This move was part of the insurers' attempt to maximize investment returns by saving hedging costs. However, hedging costs are necessary, to contain the overall volatility of total forex costs to within a certain range (see chart 6).

Chart 6

### Hedging Costs Necessary To Maintain Resilience

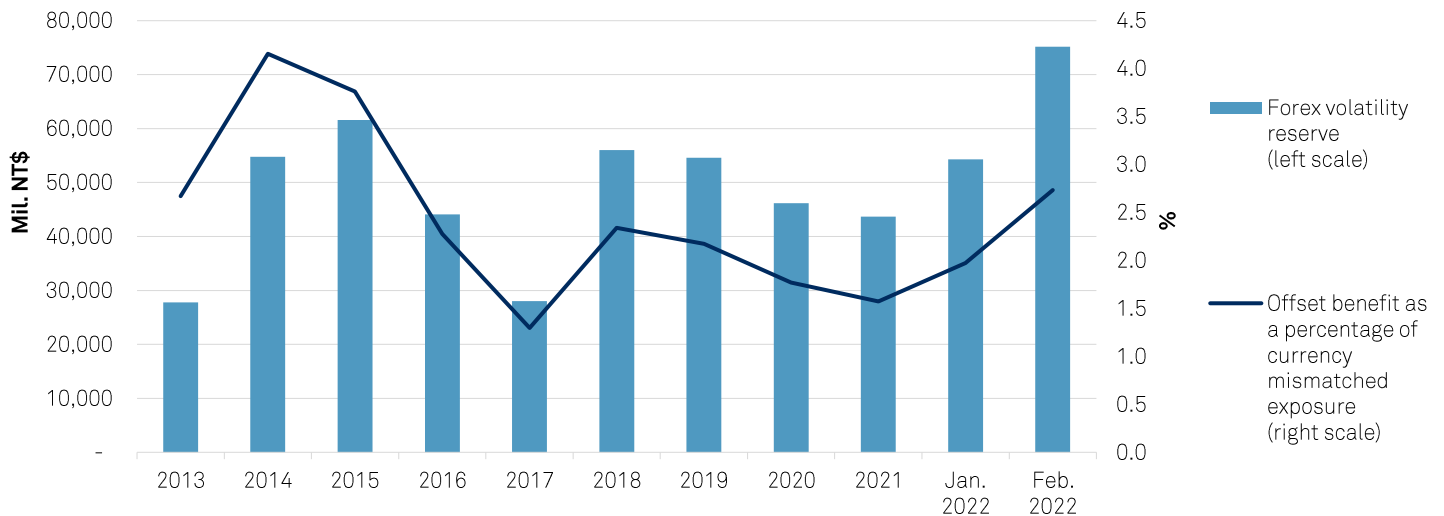


\*Due to data availability, for 2018-2019, we use 'net hedging costs' which is the combination of revaluation gains or losses on hedging tools and currency swap costs on hedging tools. Source: Financial Supervisory Commission of Taiwan, S&P Global Ratings, Taiwan Ratings Corp.

Many insurers' reliance on forex volatility reserves to offset profit shocks from currency risk has grown over the years. We acknowledge the reserve could provide a buffer against forex volatility. But the potential offset benefit of the forex volatility reserve has trended down as the mismatched exposure has grown. We note, however, that the outstanding balance of total forex volatility reserves has recently grown on the back of forex gains after U.S. dollar appreciation in the first two months of 2022 (see chart 7).

**Chart 7**

**Declining Offset Benefits From Forex Volatility Reserve**



Source: Taiwan Insurance Institute, Financial Supervisory Commission of Taiwan, S&P Global Ratings, Taiwan Ratings.

**Beware Profit-Oriented Forex Management**

We consider the high foreign-exchange risk exposure brings additional capital risks, albeit at a manageable level for most insurers. Under our base case assumption, potential forex-related costs could account for 3%-4% of adjusted total capital under an assumed 3% yearly volatility of the Taiwan/U.S. dollar exchange rate during 2022.

However, such incremental capital risk could still put rating pressures on a few life insurers that have slim capital buffers, below-average investment performances, and above-average forex risk exposure. We may take negative rating actions on insurers that overly emphasize profits at the cost of aggressively widening their forex risk-taking. Forex costs could be amplified without appropriate risk monitoring mechanisms that calculate the potential cost of the risk-taking and formulate appropriate responses.

We acknowledge the significance of earnings management. Resilient, good quality earnings underpin capital generation and demonstrate management's ability to attain set goals. On the other hand, in the unpredictable forex market, an overly profit-oriented mindset for forex risks could lead to profit shock and capital erosion.

In a scenario of 6%-8% yearly volatility of the Taiwan/U.S. dollar exchange rate, many insurers could face difficulty in maintaining stable credit profiles. This scenario is unlikely over the next two years but has occurred in the past decade. Such high volatility is likely to coincide with unfavorable capital market swings and place profound pressure on the sector's capitalization, which we already consider to be the sector's major weakness.

## **Related Research**

- Insurance Industry And Country Risk Assessment Update: April 2022, April 5, 2022
- Global Economic Outlook Q2 2022: No Cause For Complacency As The Russia-Ukraine Conflict Modestly Dents Growth, March 31, 2022
- Economic Outlook U.S. Q2 2022: Spring Chills, March 29, 2022
- Asia-Pacific Economic Risks, Thy Name Is Inflation, March 28, 2022
- Insurance Industry And Country Risk Assessment: Taiwan Life, July 15, 2021

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