MOODY'S INVESTORS SERVICE

SECTOR IN-DEPTH

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Life insurance – Asia-Pacific

Asset and liability management will remain disciplined amid rising rates

Summary

We expect the Federal Reserve to continue to raise interest rates to tame surging inflation. In response to the Fed's rate hikes and rising inflation, a number of central banks in Asia-Pacific have gradually raised their policy rates. Against this backdrop, we surveyed rated life insurers in four markets in Asia-Pacific about their strategies for investment and asset-liability management. We received responses from 16 insurers (Exhibit 1). The survey results show that life insurers will remain disciplined in asset and liability management as rate rises. This will alleviate insurers' negative spread risk and their balance sheet sensitivity to interest rate movement, if they act as responded. The rising rates is particularly beneficial to Taiwanese and Korean insurers to manage their negative spread burden.

» **Insurers look to increase fixed-income investments but drastic changes to their asset mixes are unlikely.** Most survey respondents plan to moderately increase asset allocations to fixed-income investments in the next 12-18 months to take advantage of rising yields. Still, most insurers do not plan to significantly change their allocation percentage to each asset classes. We believe this is because insurers also increasingly need to consider the features of their policy liabilities in devising strategies for asset allocations as they prepare for more stringent capital requirements under more advanced risk-based capital regimes and IFRS 17.

» **Most insurers expect investment yields to fall as increases in hedging costs outweigh rises in bond yields.** The majority of the survey respondents expect their overall investment yields after hedging costs to fall from 2021 levels in the next 12-18 months. The widening differentials between the still low interest rates in insurers' domestic markets and the rising rates in US are raising costs for foreign-currency derivatives, which insurers generally see outweighing rises in new money yields on bonds.

» **Insurers will maintain conservative approaches to asset allocations as they face a range of risks.** As interest rates rise, survey participants are most concerned about recession risk, interest rate risk that arise from mismatches of asset-liability durations and credit risk. To guard against such risks, insurers will generally be cautious about asset allocations to equities and uphold the credit quality of their bond holdings.

» **Insurers will continue to be disciplined in liability management.** About 94% of the respondents do not plan to increase their guaranteed rates on their insurance products in the next 12-18 months. Insurers are also cautious about offering long-term policies with high guaranteed rates.

Exhibit 1

More than 15 insurers from four markets participated in the survey

Insurers headquartered in	Number of insurers providing feedback
Hong Kong SAR, China	3
Japan	7
Korea	4
Taiwan, China	2
Total	16

Source: Moody's Investors Service

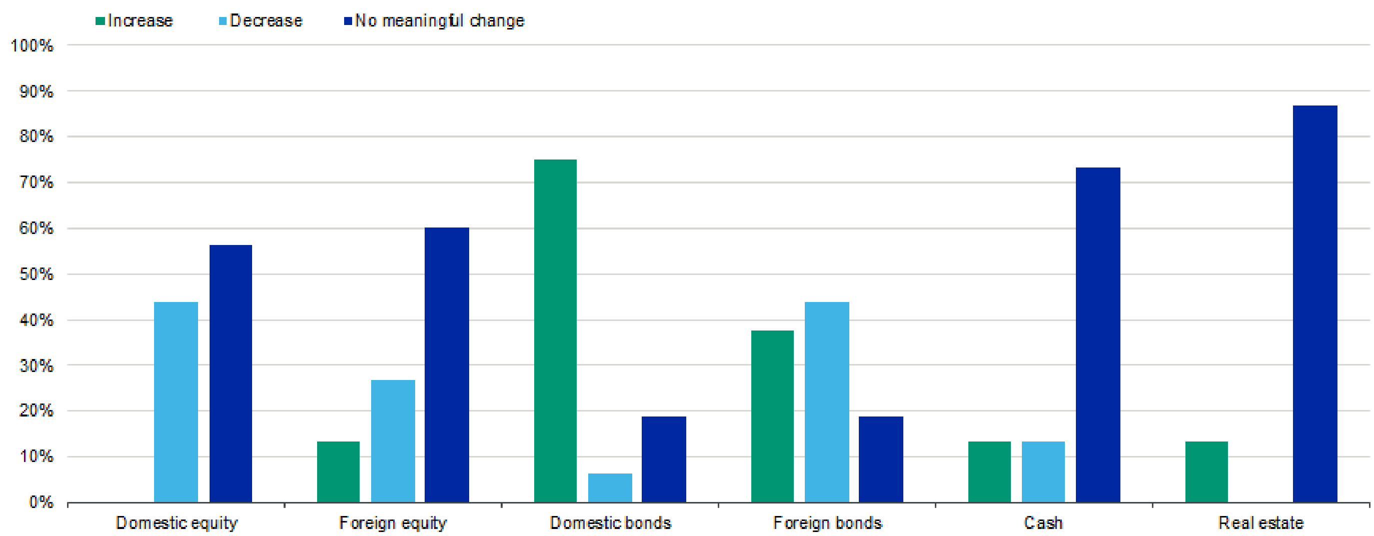
Insurers look to increase fixed-income investments but drastic changes to their asset mixes are unlikely

Most survey respondents plan to moderately increase asset allocations to fixed-income investments in the next 12-18 months to take advantage of rising yields (Exhibit 2). Still, most insurers do not plan to significantly change their allocation percentage to each asset classes. We believe this is because insurers also increasingly need to consider the features of their policy liabilities in devising strategies for asset allocations as they prepare for more stringent capital requirements under more advanced risk-based capital regimes and IFRS 17, which will be implemented in the coming years.

Exhibit 2

Insurers are keen to increase domestic fixed income investments but an overhaul on overall asset mixes is unlikely

Survey participants' planned changes in their asset allocations in the next 12-18 months



Sources: Companies, Moody's Investors Service

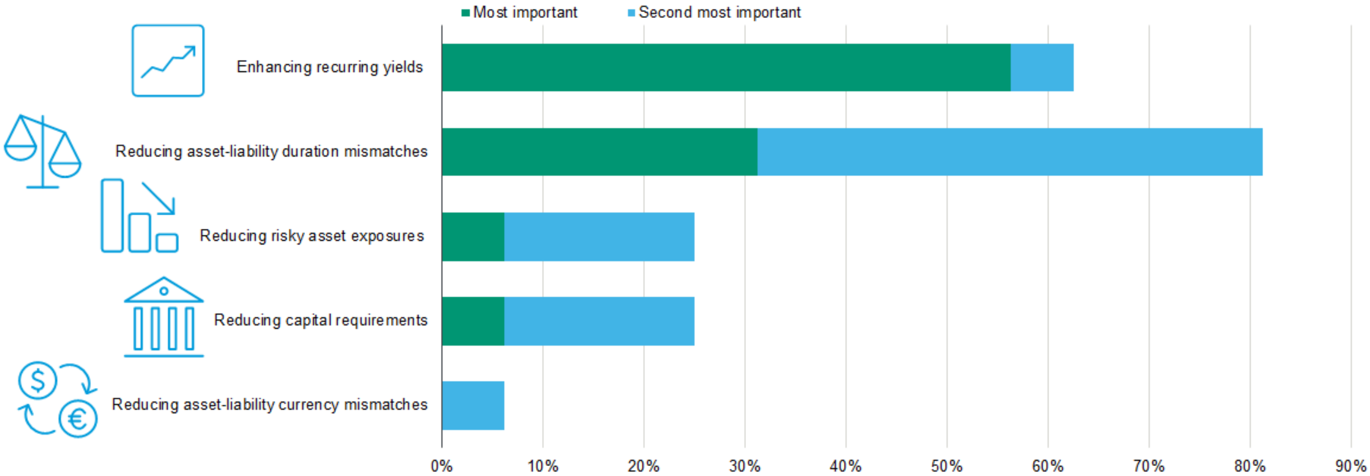
Most insurers cite recurring yield enhancement and reductions in mismatches between the durations of assets and liabilities as key factors (Exhibit 3) for their planned asset mix changes. These objectives, if achieved, would be credit positive for insurers because they would reduce their negative spread risks and the sensitivity of their balance sheets to interest rate changes under IFRS 17.

The benefit from rising rates would be particularly prominent to Taiwanese and Korean insurers to manage their negative spread burden, stemming from large blocks of policies guaranteeing high rate and underpinned by their high costs of liabilities among peers (Exhibit 4).

Exhibit 3

Recurring yield enhancement and reductions in asset-liability duration mismatches will drive insurers' planned asset mix changes

Key factors for planned changes in asset allocations ranked by survey participants



Sources: Companies, Moody's Investors Service

Japanese and Korean insurers are commonly keen on adding long-dated domestic bonds to lengthen their asset durations and reduce their capital requirements to cover asset-liability duration mismatches in anticipation of the adoption of more advanced risk-based capital regimes in the coming years. Rises in domestic interest rates from low levels, especially at the superlong end of the yield curve in Japan, makes domestic bonds a more economical option than foreign ones for insurers to cover the costs of liabilities without exposing themselves to foreign-exchange risks.

Although unhedged foreign bonds generally offer higher yields than domestic bonds, most Japanese insurers have plans to reduce allocations to the former. This reflects their intention to reduce capital charges associated with currency mismatches, stemming from foreign investments being backed by liabilities that are predominantly denominated in yen (Exhibit 4).

Japanese insurers have lower costs of liabilities and longer liability duration than their peers in Asia, which enable them to invest in longer term domestic government bonds while maintaining duration matching. They also have lower reliance on investment spread gains for earnings. These features give them more flexibility to shift away from foreign bonds.

Korean insurers are more divided in their strategies for allocations to foreign bonds. This is mainly a result of balancing between yield enhancement to cover high cost of liabilities and the management of foreign-exchange risks.

Exhibit 4

Liability features and levels of domestic bond yields are key factors determining insurers' strategies in foreign bond investment

Market	Moody's estimate of industry cost of liabilities	Moody's estimate of industry liability duration	Domestic government bond yield at September 6 2022	Moody's estimate of industry foreign currency policy-backed reserves as % of total reserves	Moody's estimate of industry foreign investment (mainly foreign bonds) as % of total investments
Taiwan	3.0%-3.7%	12-14 year	10 year: 1.3% 20 year: 1.6%	15%-20%, and rising reflecting insurers' strong new business from USD-denominated policies	55%-65%
Korea	3.3%-4.4%	9-11 year	10 year: 3.7% 20 year: 3.6%	Minimum	12%-13%
Japan	1.7%-2.2%	15-21 year	10 year: 0.2% 20 year: 0.9%	Foreign currency policy-backed reserves unlikely to form a meaningful portion given Yen-denominated policies contribute a majority of reserves	25%-35%

Sources: Companies, Moody's Investors Service

Taiwanese insurers remain highly keen on purchasing long-dated foreign bonds to enhance their recurring yields and lengthen their asset durations. This is driven by the need to cover their high costs of liabilities and their heavy reliance on spread gains for earnings. Also, the proportion of Taiwanese insurers' USD-denominated liabilities is increasing because USD-denominated policies generate substantial new business premiums. Further, still-low domestic interest rates and a lack of depth in the domestic bond market remain key hurdles for insurers to meaningfully increase asset allocations to domestic bonds. As such, Taiwanese insurers will continue to have significant currency mismatches between assets and liabilities.

Most insurers in Japan, Korea and Taiwan do not plan to increase their asset allocations to floating-rate bonds in the next 12-18 months.

Hong Kong-based insurers' strategies for fixed-income investments are more diverse. Insurers that already have well-matched durations of assets and liabilities are more open to floating-rate investments or real estate for yield enhancement. On the other hand, some insurers plan to shorten the terms of their insurance policies to reduce charges for interest rate risks as they prepare for new risk-based capital requirements. Resultant reductions in durations of policy liabilities could limit these insurers' demand for long-dated bonds.

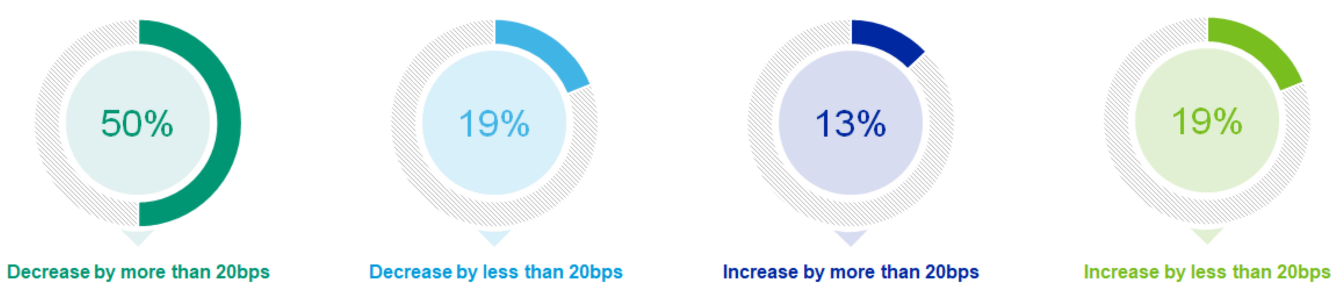
Most insurers expect investment yields to fall as increases in hedging costs outweigh rises in bond yields

The majority of the survey respondents expect their overall investment yields after hedging costs to fall from 2021 levels in the next 12-18 months (Exhibit 5), with more than half of the participants anticipating declines of more than 20 basis points, which is contrary to the belief that interest rate hikes should be positive for insurers. The insurers bracing for falls in their investment yields mostly expect increases in hedging costs (Exhibit 6) to outweigh rises in new money yields on bonds. The widening differentials between the still low interest rates in insurers' domestic markets and the rising rates in US (Exhibit 7) are raising costs for foreign-currency derivatives, including currency swaps.

Exhibit 5

Most insurers expect declines in investment yields

Survey participants' expectations of changes in investment yields after hedging costs from 2021 levels

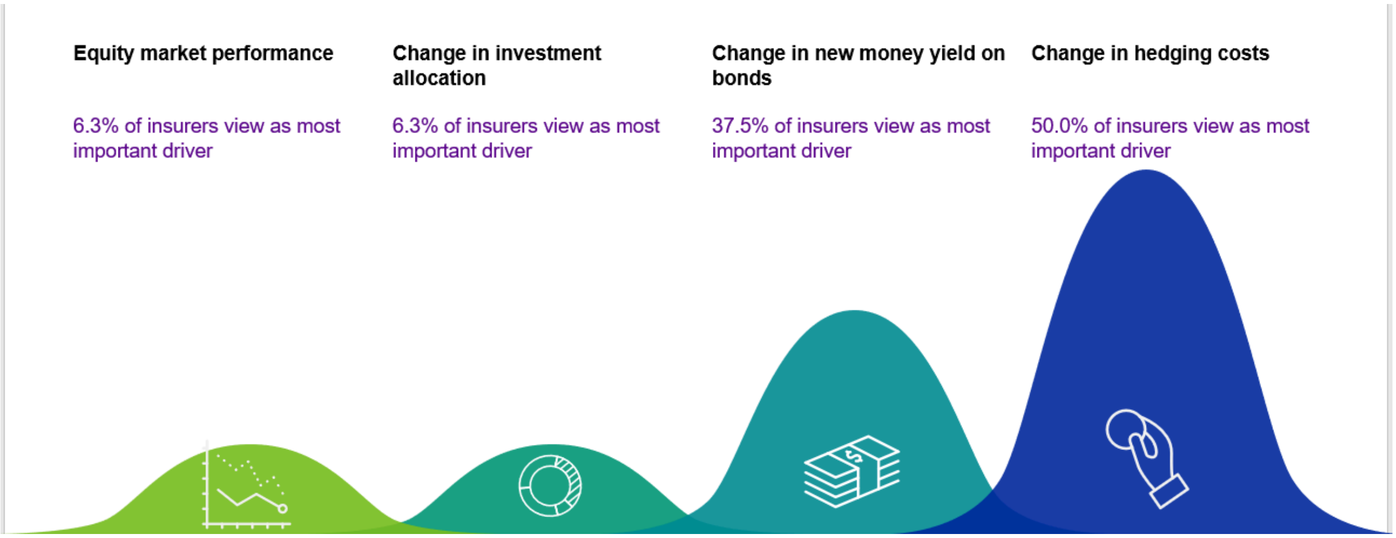


Sources: Companies, Moody's Investors Service

Exhibit 6

Hedging costs and new money yield on bonds are key factors of insurers' expectations of investment yields

Factors affecting investment yields ranked by survey participants

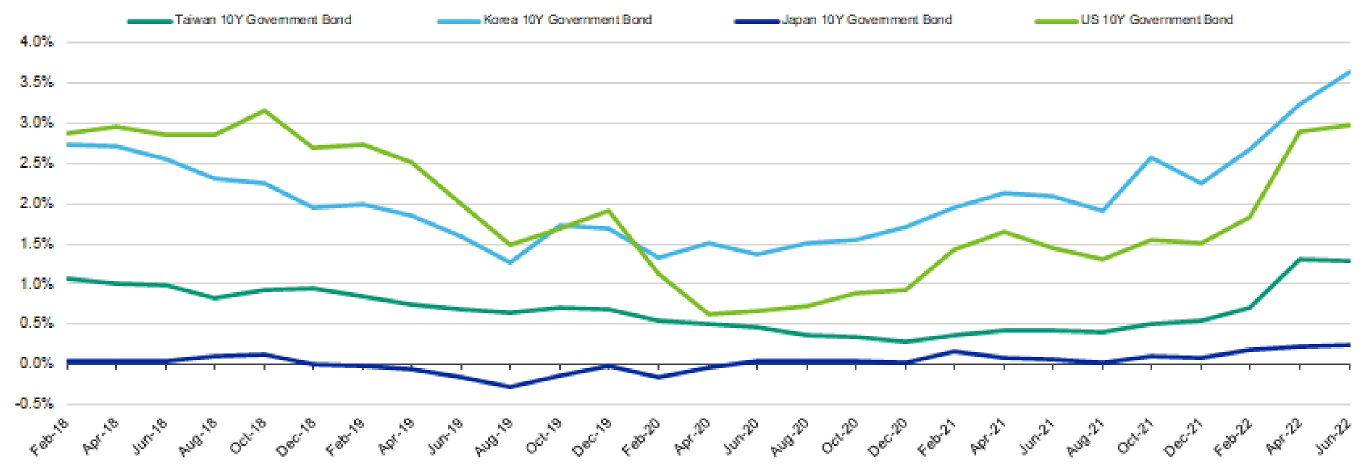


Sources: Companies, Moody's Investors Service

Exhibit 7

Widening differentials between the rising rates in US and still low interest rates in domestic markets, except for Korea

10-year government bond yields



Sources: Bank of Korea, Central Bank of the Republic of China (Taiwan), Federal Reserves, Ministry of Finance Japan, Moody's Investors Service

Specifically, most Japanese insurers expect their investment yields to decline. This expectation not only reflects increases in hedging costs, but also declines in returns on equities and their shift away from higher-yielding unhedged foreign bonds. Taiwanese and Korean insurers, however, are more divided among themselves in their expectations of changes in their investment yields, likely because they have diverging view on the net impacts between increases in hedging costs and rises in new money yields on bonds.

We expect rising rates will be more beneficial to Korean insurers' yield enhancement. The interest rate in Korea is still slightly higher than that in US, though the gap is narrowing. Coupled with Korean insurers' lower allocation to foreign bonds, these result in less significant hedging cost burden to them. Besides, the new money yield of domestic bonds in Korea has picked up more substantially than that in Taiwan and Japan since early 2022. Taiwanese insurers will also benefit from strong rise in new money yield for their significant allocation to USD-denominated foreign bonds but their hedging costs increase will be more significant.

In response to increasing hedging costs, most Japanese and Taiwanese insurers plan to reduce their use of currency derivatives for their new investments in foreign bonds or terminate parts of their rolling hedges on existing holdings. Although the dollar appreciation boosts foreign-exchange gains for insurers, cuts in hedging ratios[1] will inevitably increase the sensitivity of insurers' earnings to changes in foreign-exchange rates.

Korean insurers do not plan to reduce their hedging ratios because regulators in the country recommend they maintain hedging ratios of at least 85%. Some of them plan to shorten their currency hedging instrument terms to be more flexible with their hedging strategies amid volatile market conditions.

Hong Kong-based insurers are the least concerned about the impact of rising hedging costs because the currency peg between the Hong Kong dollar and the US dollar means their use of currency hedging is limited. Hence, most of them expect their investment yields to rise, even as they shift to higher-rated bonds, including foreign-currency ones, as well as real estate.

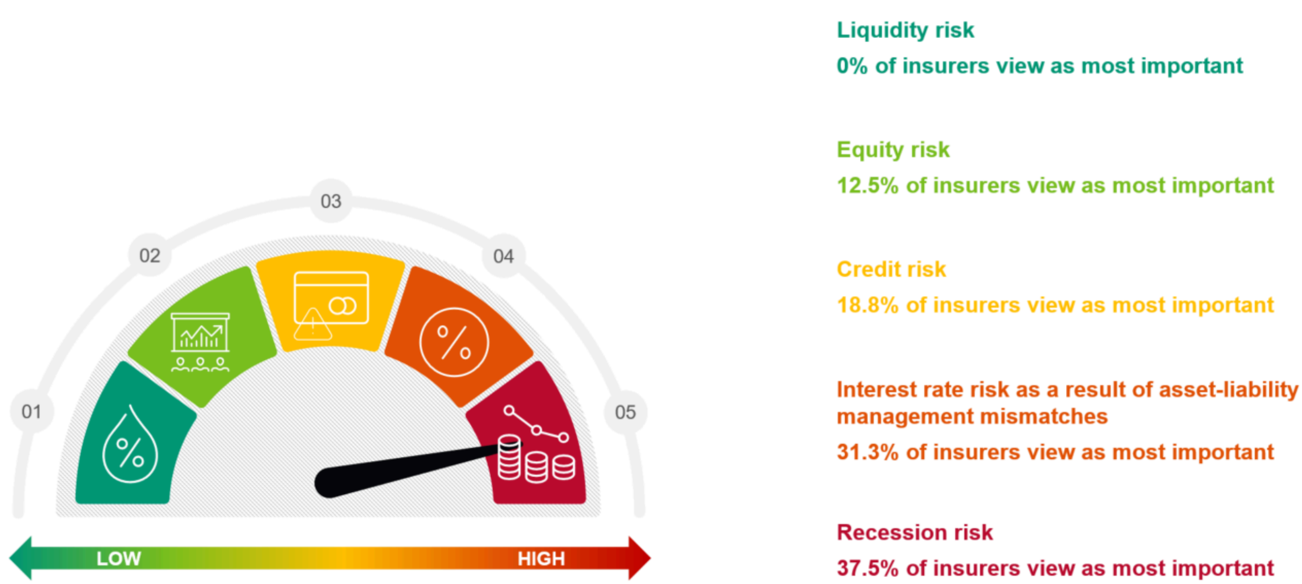
Insurers will take conservative approaches to asset allocations as they face a range of risks

As interest rates rise, survey participants are most concerned about recession risk, interest rate risk that arise from mismatches of asset-liability durations and credit risk (Exhibit 8). To guard against such risks, insurers will generally take conservative approaches to asset allocations.

Exhibit 8

Insurers are most concerned about recession risk, interest rate risk and credit risk

Key investment risks amid rising rates ranked by survey participants



Sources: Companies, Moody's Investors Service

Amid growing concerns about recession risk, which could lead to declines in corporate profit and increased volatility in equity markets, most insurers plan to maintain the allocation to equities at same percentage in the next 12-18 months. Insurers are also gradually shifting to dividend-yielding stocks, partly to reduce the sensitivity of their earnings to changes in equity prices under IFRS 9. This will help strengthen insurers' asset quality.

As credit risk grow because of increasing borrowing costs and tightening market liquidity, all insurers intend to uphold the credit quality of their bond portfolios to minimize potential losses from defaults or a widening of credit spreads.

Most Japanese and Korean insurers plan to maintain average credit ratings of their bond portfolios at current levels in the next 12-18 months because they already have relatively large allocations to A-rated bonds and minimal holdings of non-investment grade bonds. On the other hand, some Hong Kong and Taiwanese insurers plan to improve average credit ratings of their bond investments as rising yields allow them to increase allocations to A-rated or above bonds while meeting their investment return targets, which are higher than those of their peers in Asia. This will also help reduce credit risk charges for these insurers under their new capital regime.

To hedge interest rate risk and reduce asset-liability duration mismatches with better cost efficiency, Korean insurers are increasing their use of bond forwards. We expect such trend to continue into 2023 with the roll-out of new capital regime and the rise in interest rates.

Rising interest rates will inevitably increase mark-to-market losses on bonds and could strain insurers' accounting capitalization and earnings. Taiwanese and Korean insurers are particularly vulnerable because their insurance assets are mark-to-market and suffer valuation losses while their insurance liabilities are still discounted using historical lock-in rates and remain unchanged despite rising interest rates. However, we believe such losses are accounting-based rather than economic, because they generally have good liquidity to hold their bond investments to maturity. However, if the accounting losses would cause the calculation of their capital to fall close to regulatory minimum thresholds, insurers could be under pressure to raise additional capital to meet regulatory requirements.

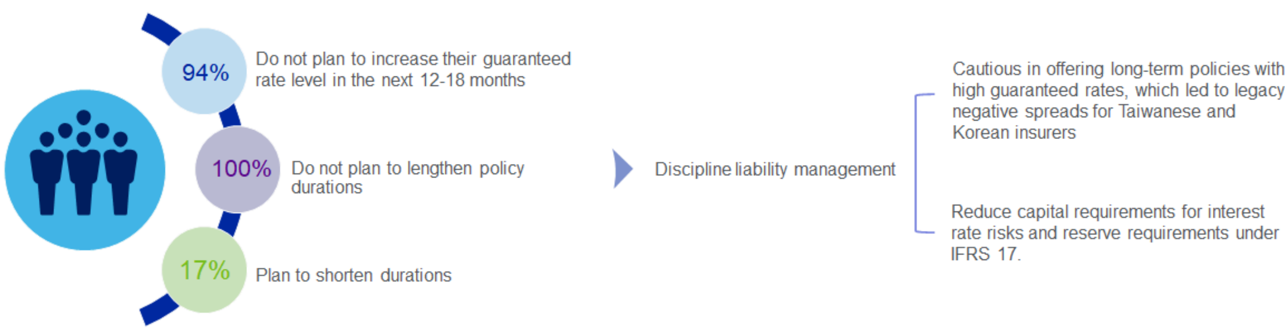
Insurers will continue to be disciplined in liability management

Our survey results show that insurers will remain disciplined in their liability management despite rising new money yields on bonds (Exhibit 9).

Exhibit 9

Insurers will remain disciplined in liability management

Survey participants' planned changes in their liability management in the next 12-18 months



Sources: Companies, Moody's Investors Service

About 94% of the respondents do not plan to increase their guarantee rates for their insurance products in the next 12-18 months despite the increase in market interest rates. Insurers are also cautious about offering long-term policies with high guaranteed rates, which was part of the reasons for the legacy negative spreads for Taiwanese and Korean insurers. None of the survey participants plan to lengthen their policy durations, while 17% of them plan to shorten their policy durations. We believe this is because insurers are seeking to reduce capital requirements for interest rate risk and reserve requirements under IFRS 17.

About 33% of the respondents plan to increase their non-guarantee crediting rates to offer more attractive rates for their policyholders as yields on deposits and other savings-type wealth management products rise. Insurers can share investment risks with policyholders by lowering rates if their investment yields are not as high as they expected when pricing their policies. Also, increasing regulatory oversight over how insurers set non-guaranteed rates will curtail aggressive hikes in rates.

Chinese life insurers are a camp on its own as interest rates are declining

Chinese life insurers, which primarily invest in domestic markets, have different strategies for asset and liability management from those of their peers in other parts of Asia. This is because the Chinese central bank maintains accommodative monetary policy to support economic growth amid challenges arising from efforts to curb coronavirus outbreaks and the property market fallout. This results in yield declines on both domestic bonds and alternative investments.

We do not expect Chinese insurers to significantly change their allocations to domestic bonds despite falling yields because they seek assets with stable yields to cover their insurance liabilities.

The regulatory scrutiny over the structures of alternative investments, such as trust plans and debt schemes, has curtailed supply and demand for these assets. That said, some insurers still intend to make alternative investments for yield enhancement, provided that they can source investments with good credit quality and clear structure. We expect some insurers to redirect proceeds from their maturing alternative investments to local government bonds or domestic equities. Rising equity exposure will increase the sensitivity of earnings and capitalization to changes in equity prices.

We also expect a growing number of Chinese insurers to reduce non-guarantee crediting rates for their participating and universal life products to mitigate pressures on investment spread gains as interest rates fall.

Moody's related publications

Industry outlook

» Life Insurance - Korea: Outlook stable amid rising interest rates and solid capital for transition to new capital regime, May 2022

» Life insurers - China: Strengthened capital regime and steady asset risk support stable outlook, February 2022

» Life Insurance – Japan: Outlook changed to stable as resilient profit supports strong capitalization, June 2021

» Life insurers - Taiwan: Outlook negative as prolonged low rates keep spread income weak and vulnerable, May 2020

Sector in-depth/sector comment

» Dai-ichi Life, Meiji Yasuda Life, Nippon Life, Sumitomo Life: Fiscal 2021 update : Higher investment margins drive growth in core profits, but mortality margins decline, June 2022

» Insurance – China: Capitalization overall remains solid despite ratios decline under C-ROSS Phase II, May 2022

» Life insurers – Japan: Yen's moderate depreciation has minimal impact on Japanese life insurers, steepening yen yield curve is credit positive, April 2022

Methodology

» Life Insurers Methodology, August 2022

Endnotes

1 Proportion of foreign investments hedged by foreign-currency derivatives

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