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Life Insurance - Korea

IFRS 17 Will Reduce Reported Capitalization, But Drive Structural Improvements

Summary Opinion

Implementation of International Financial Reporting Standard (IFRS) 17 Insurance Contracts, (formerly known as IFRS 4 Phase II) in Korea will challenge life insurers' capitalization by requiring them to measure their policy liabilities at current value. However, beyond this adjustment pressure, the new standard will, over time, promote structural improvements and value creation in the industry.

Korean life insurers are preparing for the new accounting standard that is scheduled to be finalized by the International Accounting Standards Board (IASB) in May 2017, and will come into effect on 1 January 2021. The Financial Services Commission (FSC) and the Financial Supervisory Service (FSS) in Korea have announced that they will issue guidelines to insurance companies after the finalized standards of IFRS 17 are released.

Insurers' capitalization profiles will come under pressure as fair valuation of liabilities drives higher reserves. Under IFRS 17, the banning of netting between policy surplus and deficits, and the use of market-consistent discount rates – which will likely be lower than the average discount rates currently used by Korean insurers – to arrive at best estimate liability (BEL), will result in broadly lower reported capitalization. The impact will be more significant for insurers that have a large book of negative spread in-force business. As a result, insurers will be under pressure to strengthen their capitalization, with many likely to do so by hybrid bonds issuance.

IFRS 17 will promote structural improvements in the industry. The new measurement requirements will lead to improved insurers' pricing discipline and product mix by better reflecting the true economic cost of embedded options and guarantees in their products. Also, it will encourage insurers to sell more longer-term protection products instead of volume-driven short-term savings products. On the other hand, the industry has been increasing its sales of higher-margin healthcare and critical-illness products, and we expect this trend to continue as IFRS 17 is implemented.

IFRS 17 also provides a strong incentive for insurers to reduce their duration mismatch. The new accounting standard requires closer monitoring and matching of economic assets and liabilities. We expect IFRS 17 to push the industry towards more dynamic asset liability management and investment strategies to minimize duration

mismatch and associated interest-rate risk exposure. This will reduce the potential sensitivity of insurers' solvency and earnings to financial market shocks.

Smaller insurers will face greater operational challenges. More explicit recognition and disclosure of the contractual service margin (CSM) and risk margin under IFRS 17 will expose smaller insurers to relatively weak earnings quality as they rely heavily on spread income. These insurers would face more difficulty in adapting to IFRS 17, and in addition they will need to devote substantial resources and incur adjustment costs to meet the more stringent measurement and disclosure standards.

Insurers' capitalization will come under pressure from fair valuation of reserve liabilities

Korean life insurers are preparing for the adoption of IFRS 17 Insurance Contracts, which is scheduled to be finalized by the IASB in May 2017 and will come into effect on 1 January 2021. The FSC and FSS in Korea have announced that they will issue guidelines to insurance companies after the finalized standards of IFRS 17 are released.

The key impact of IFRS 17 on insurers is the current value assessment of their policy liabilities under a "Building Block Approach"[1]. The current practice of netting policy surplus and deficits under a current liability adequacy test (LAT) across product categories is no longer allowed. Insurance contracts with deficits need to be recorded as liability, which translates to a decrease in reported capitalization.

Specifically, IFRS 17 will require insurers to:

» Use market-consistent discount rates to arrive at their BEL. This contrasts to the current standard where policy reserves are valued based on the historical "locked-in" interest rates at policy inception.

» Discount future cash flows by using a bottom-up or top-down approach[2], which includes an allowance for risk and uncertainty to best reflect the characteristics of insurance liabilities. It will allow insurers to set their discount rates above the risk-free rate with a spread, based on their own specific experience.

» Recognize profits only as services are being provided. Insurers will book unearned profits as a CSM liability at policy inception, which will be amortized into profit and loss over the insurance contract term. This replaces the current practice of immediately recognizing all premium income and acquisition costs upfront as "Day 1 profit". However, "Day 1 loss" is still recognized immediately.

The above change is particularly relevant for Korean insurers because the current interest rate assumptions insurers would use to value these liabilities is much lower, which will raise the policy reserves and result in lower reported capitalization. The impact is particularly significant for life insurers with large blocks of policies issued prior to 2003, when these policies generally carried guaranteed rates exceeding 6%. Currently, reserves for these legacy policies are primarily determined by prevailing rates[3] (equivalent to locked-in rates and could be at 6% or above) at policy inception, which tend to be higher than current market rates.

Under IFRS 17, these reserves will be discounted using much lower market consistent discount rates (Exhibit 1). This reflects current interest rates in Korea remaining low despite a rebound in recent months, with the 20-year Korean bond yield averaging 2.2% in the first quarter of 2017. Most, if not all, insurers will see their policy liabilities increase from recalibrating their measurement under IFRS 17, which in turn will weaken their capitalization.

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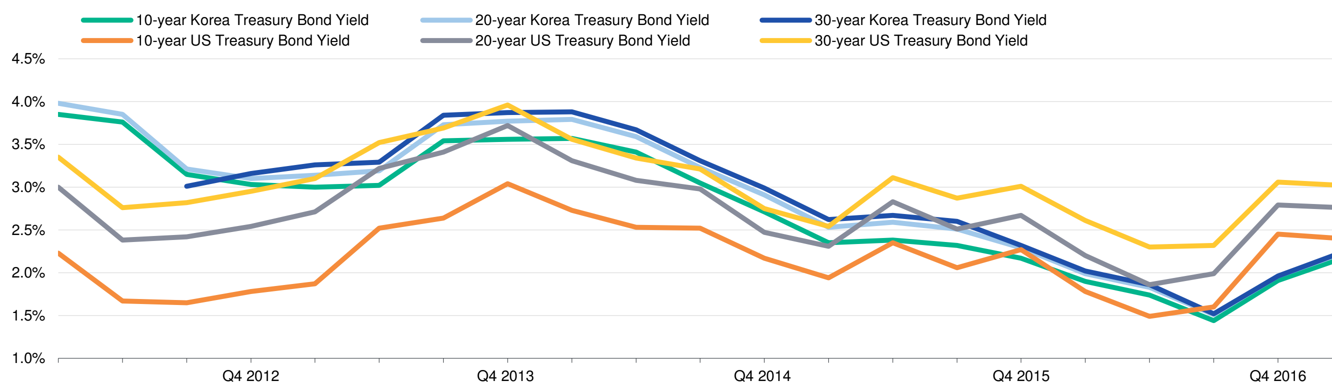
Exhibit 1

Korean Rates vs US Rates



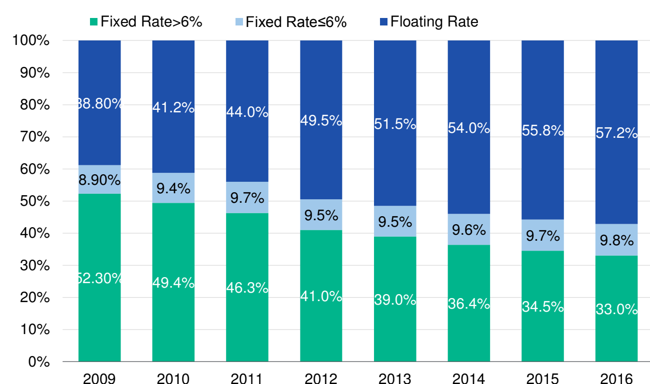
30-year Korea treasury bond yield in Q1-Q2 2012 is not available from Bank of Korea
Source: Bank of Korea, Federal Reserve

In anticipation of the adoption, some insurers have responded to this development by shifting to a more balanced policy mix. They have made more progress in de-risking their product portfolios by promoting products with lower guarantee rates and floating rates. Floating rate products feature periodic resets of crediting rates, allowing insurers to adjust their costs of liability to the prevailing interest rate environment.

Exhibits 2 and 3 illustrate the reserve breakdowns of the top two life insurers in the domestic market – Samsung Life Insurance Co., Ltd (unrated) and Hanwha Life Insurance Co., Ltd (unrated) – whose fixed-rate products have declined consistently in recent years. Accordingly, the cost of liabilities for Samsung Life has fallen to 4.53% from 6.04% between 2009 and 2016, while that of Hanwha Life fell to 4.79% from 6.38%. We expect this downward trend to continue.

Exhibit 2

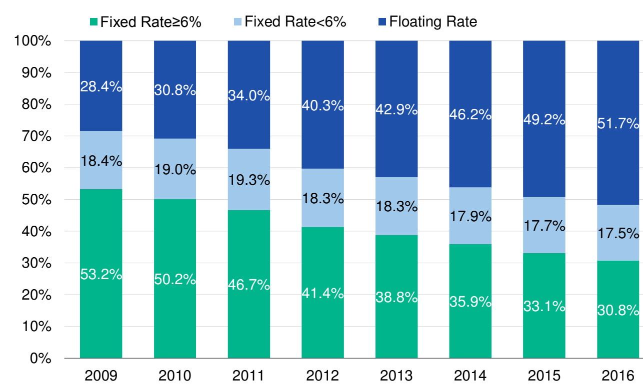
Reserve Breakdown of Samsung Life



Fiscal YE as of March 31 for 2009-2012 and December 31 for 2013-2016
Source: Company data, Moody's

Exhibit 3

Reserve Breakdown of Hanwha Life



Fiscal YE as of March 31 for 2009-2012 and December 31 for 2013-2016
Source: Company data, Moody's

Aside from continued growth in products with lower guarantee rates, leading insurance companies generally have stronger balance sheets with LAT surpluses larger than deficits across their business lines. This situation suggests that these companies will be less impacted by the cessation of LAT netting.

Hybrid bond issuance a probable response to need for capital replenishment. A more immediate concern is the potential capital shortfall that comes with the implementation of new accounting standards and the more stringent reserve requirements, particularly for life insurers that suffer negative spreads on their legacy policies. A few life insurers have already responded to the potential capital shortfall by announcing, or considering, capital raising through debt issuance and equity injection.

For example, Hanwha Life has issued hybrid bonds of KRW500 billion on 7 April 2017 for capital enhancement. Also, NongHyup Life Insurance Co., Ltd (unrated) announced in February 2017 that it would issue KRW300 billion subordinated debts in the first half of the year.

In particular, we expect hybrid bond issuance to be a key channel insurers will tap because companies will receive more favorable regulatory treatment over subordinated debt as a form of capital enhancement. Under the current risk-based capital regime, hybrid bonds of up to 15% of total shareholders' equity will qualify as available core capital. In addition, the coupon payments on these bonds are paid as dividends, which do not have an earnings impact on insurers' profit and loss statements.

In contrast, insurers' subordinated debt issuance only qualifies as supplementary capital. It is subject to regulatory approval and the total amount that can be recognized as supplementary capital must be less than or equal to 50% of core capital. Moreover, for subordinated debts with a maturity period of less than five years, 20% of face value must be deducted every year, which will undermine the solvency position of insurers.

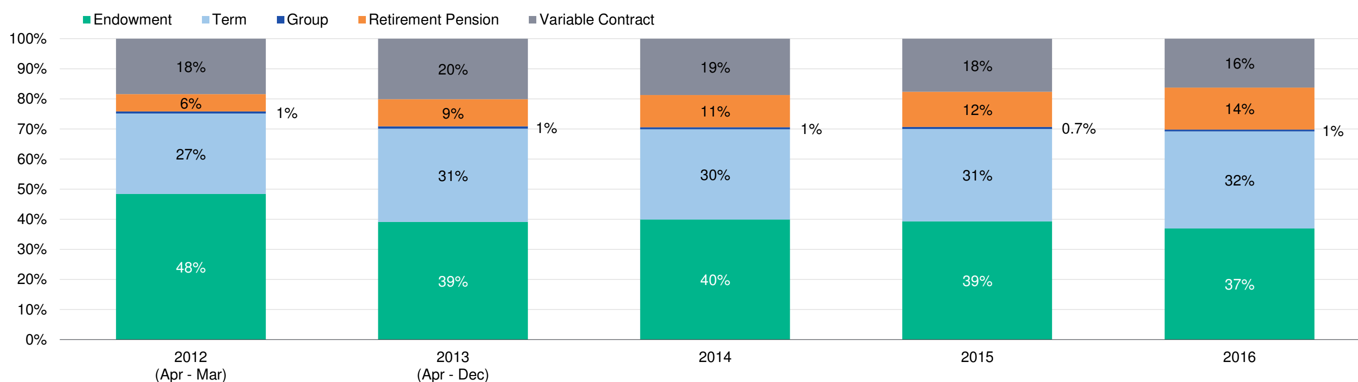
IFRS 17 will promote structural improvements in the industry

While IFRS 17 will raise capitalization pressure on the industry as it is being implemented, the new standard will also promote structural improvements that we expect will ultimately strengthen the industry's credit fundamentals.

The adoption of IFRS 17 will improve the industry's pricing discipline and product mix. The use of market-consistent discount rates to arrive at the BEL will allow insurers to reflect the true economic cost of embedded options and guarantees in their products. Also, it will shift the industry's incentive away from short-term volume-driven profits. The more explicit recognition of CSM and risk margin will expose the earnings quality of insurers' portfolios. This will discourage life insurers from selling short-term savings products with high guarantees. Instead, the new accounting standard will incentivize insurers to sell more protection products -- including long-term healthcare and critical-illness products -- with higher risk margin.

As shown in Exhibit 4, the industry's premium income generated from protection products (grouped as "Term" products) and retirement pension products increased in 2016. The implementation of IFRS 17 will extend this trend.

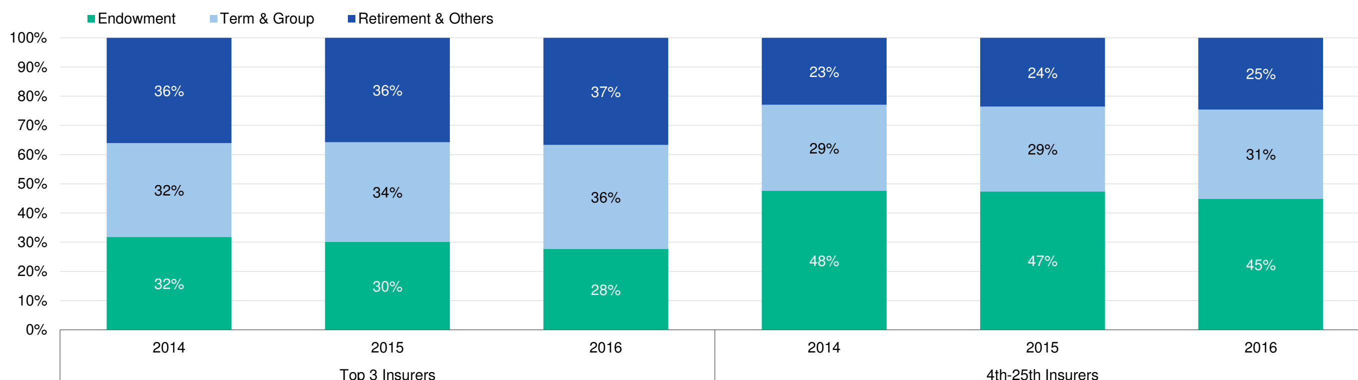
Exhibit 4
Industry's Product Mix



Note: Protection products, such as health and critical illness, are included in Term products category
Source: Financial Supervisory Service (FSS), Korea Life Insurance Association (KLIA), Moody's

The top-three insurers have a head start in this shift to protection products (Exhibit 5), and it will take years for the rest of the industry to catch up. This is mainly because large insurers have strong franchises and large agency forces that make them more competitive in selling protection products. Small to mid-sized insurers are still mostly reliant on savings policy sales through bancassurance. Following IFRS 17, insurers that have stronger distribution capabilities to support their target product strategy will benefit from a wider competitive advantage.

Exhibit 5
Product Mix: Top 3 Insurers [1] vs the Remaining Insurers

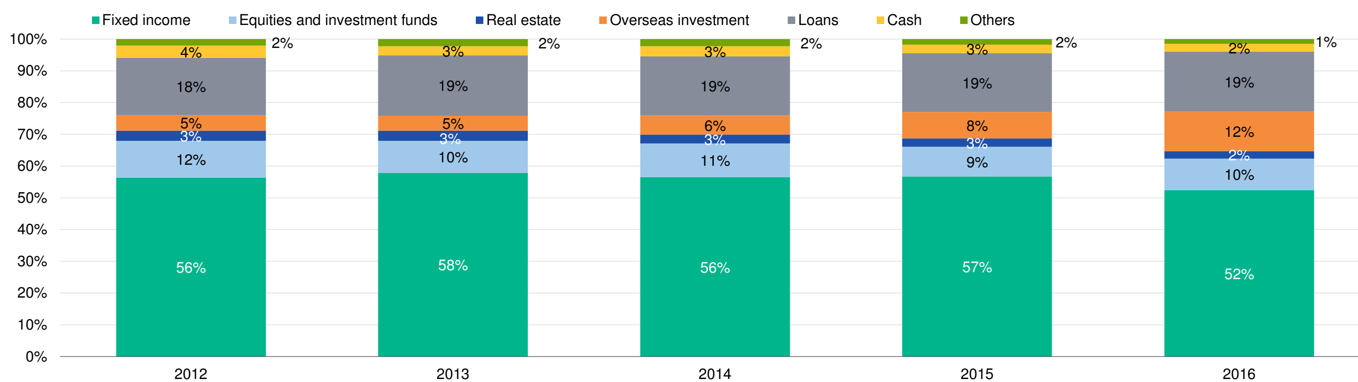


[1]Top 3 insurers accounted for 46.2% of the industry's total premium in 2016
Source: FSS, KLIA, Moody's

IFRS 17 will also strengthen insurers' duration management as it will require closer monitoring and matching of economic assets and liabilities. We expect IFRS 17 will push the industry towards a more dynamic asset-liability management and investment strategy to minimize duration mismatch and associated interest-rate risk exposure. This would consequently reduce related capital charges on insurers' solvency, as well as their earnings volatility from financial market shocks.

A key hurdle that Korean insurers face is a lack of sufficiently long-dated bonds in the domestic market to match their long-term liabilities. In response, insurers have looked outwards to fill this gap by raising their overseas investment allocation. Exhibit 6 shows that the industry has significantly increased its exposure to overseas investments in the past two years, to 12% of total cash and invested assets at the end of 2016 compared with 6% at the end of 2014.

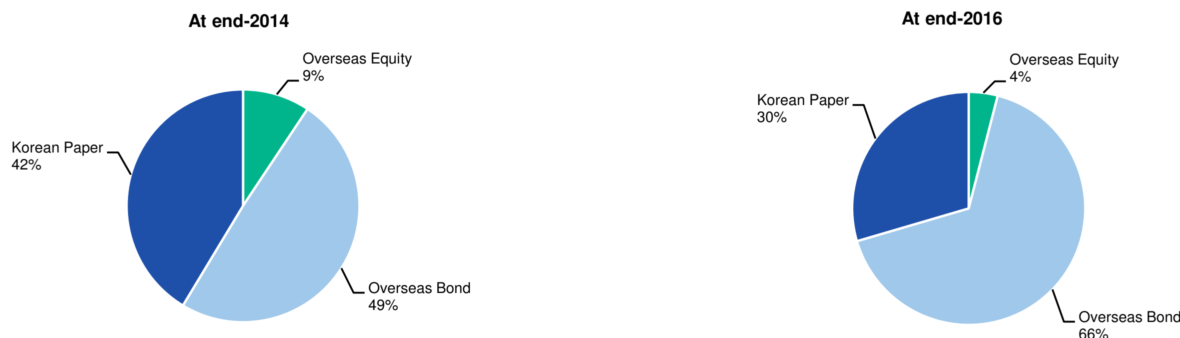
Exhibit 6
Life Industry's Investment Mix



Source: KLIA, Moody's

Bank of Korea data on overseas investment portfolios of all insurers (life and property & casualty) are in line with our view that duration matching is an expanding goal in insurers' financial management. This is because the data shows that the share of bonds in these overseas assets rose notably to 66% at the end of 2016 from 49% at the end of 2014 (Exhibit 7), with overseas assets generally having longer duration than Korean papers. Insurers' growing foreign investments will carry risks such as exposure to foreign exchange rates. However, we believe this risk is manageable through hedging strategies.

Exhibit 7
Insurance Companies' Overseas Investments



Source: Bank of Korea, Moody's

Lastly, the implementation of IFRS 17 will allow Korean insurers to report their financials based on globally accepted accounting standards, which will improve transparency and consistency. The new accounting standard allows fair comparison of the financial performance between insurers in Korea and those in other countries. This will give more comfort to foreign investors and thus facilitate domestic insurers' access to overseas capital.

Smaller Insurers Will Face More Operational Challenges During Transition

Despite the potential structural improvements of IFRS 17, the new reporting requirements will entail significant adjustment costs that will be uneven across the industry, with smaller insurers facing greater challenges.

As mentioned, most smaller insurers' current business model relies on selling short-term savings products through bancassurance and competing for top line growth. Under IFRS 17, the more explicit recognition and disclosure of CSM and risk margin will improve comparability across the industry, yet also expose smaller insurers' relatively weak earnings quality as they mainly rely on spread income.

Those smaller insurers will face more operational challenges in adapting to changes in the new accounting standards. In particular, such insurers are likely to have to make substantial investments in expanding their agency distribution to grow their protection policy sales with higher margins, as well as upgrading actuarial systems and data processes to meet the more stringent measurement and disclosure standards.

We expect the adoption of IFRS 17 will add pressure on some small and weaker insurers to slow their business growth. There is also a possibility that these insurers may even exit the market by putting themselves up for sale. This situation would perpetuate the ongoing acquisition activity in the industry over recent years. (Exhibit 8).

Exhibit 8
Recent Acquisitions in Korean Life Market

Year	Sellers (all unrated)	Stakes Sold	Acquirers (all unrated)
2013	Hana HSBC Life Insurance Co., Ltd	50% less one share	Hana Financial Group Inc.
2013	KB Life Insurance Co., Ltd.	49%	KB Financial Group Inc.
2013	ING Life Insurance Ltd.	90%	MBK Partners
2014	Woori Aviva Life Insurance	98.90%	NongHyup Financial Group Inc.
2015	Tongyang Life Insurance Co., Ltd.	63%	Anbang Insurance Group Co., Ltd
2016	Allianz Life Insurance Co., Ltd.	100%	Anbang Group Holdings Co., Ltd
2016	PCA Life Insurance Co., Ltd [1]	100%	Mirae Asset Life Insurance Co., Ltd.

[1] The sale of PCA Life to Mirae Asset Life has not yet completed. The year of 2016 refers to the announcement date.
Source: Company data, Moody's

Moody's Related Research

INDUSTRY OUTLOOK:

» Korean Banks and Life Insurance: 2017 Outlook – Negative outlook for banks reflects rising headwinds; outlook stable for insurance (Presentation), December 2016

» Korean Life Insurers: Stable Outlook Sees Improving Product Mix Offsetting Impacts From Low Interest Rates, April 2016

SECTOR COMMENT:

» Agreement to Pay Out Suicide Claims Will Weigh on Profits, But Credit Impact Manageable, March 2017

CREDIT OPINION:

» Kyobo Life Insurance Co., Ltd

RATING METHODOLOGY:

» Global Life Insurers, April 2016

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Endnotes

1 Insurance contracts will be measured using a "building block approach", which comprises of four components: (1) future cash flows; (2) time value of money; (3) contractual service margin; and (4) risk adjustment.

2 The bottom-up approach involves a risk-free rate as a starting point, to which additional characteristics of insurance liabilities are then added (for example, illiquidity premium). Under the top-down approach, insurers start from an actual or a reference portfolio of assets and then remove those characteristics that are not inherent to insurance liabilities (for example, credit risk premium).

3 An insurance company measures policy reserve by using its own estimated current interest rate at the policy inception or uses one of the following scenarios suggested by the FSS: (a) 200 scenarios of risk-free earning rate (earning rate on treasury bonds with one-year, three-year, five-year maturity) by the year suggested by the FSS; and (b) eight scenarios of risk-free earning rate (earning rate on treasury bonds with one-year, three-year, five-year maturity) by the year suggested by the FSS.

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