Financial Services Commission

Press Release

June 9, 2022

FINANCIAL AUTHORITIES HOLD MEETING TO REVIEW RISKS IN INSURANCE SECTOR

The FSC held a meeting on June 9 to review risks and discuss response measures in the insurance sector amid increasing volatility in financial environments due to increases in interest rates and the exchange rate.[1] For insurance companies' declining levels of risk-based capital (RBC) ratios as a result of steep rate hikes causing an expanded level of losses on valuation of bonds, the authorities have prepared a measure for providing a buffer to release a portion of surplus that insurance companies may recognize as available capital for calculating RBC ratios.[2]

KEY RISK FACTORS & RESPONSE MEASURES

The meeting discussed in depth the risk factors in global financial markets such as interest rate hikes and exchange rate volatility following monetary tightening by major economies amid inflation pressure and prolonging war in Ukraine and dealt with both long- and short-term response measures.

<Examples of Risk Factors in Insurance Sector>

a) **(DROP IN RBC RATIOS DUE TO RATE HIKES)** Given insurance businesses' trait of having high levels of liabilities[3] in their operating assets, recent hikes in interest rates[4] have caused considerable losses in valuation of bonds, leading to a fall in their RBC ratios (soundness indicator).

b) **(GROWING LOSS DUE TO STRONG KRW)** Due to the appreciation of the Korean won[5] following the Fed's big step announcement, the cost for forex hedging by insurance businesses[6] has increased with growing concerns about their profitability.

c) **(RISK IN ALTERNATIVE INVESTMENTS)** Although the soundness of insurance businesses' alternative investments remain at a stable level,[7] risks are growing for their alternative investments at home and abroad due to global uncertainties following the crisis in Ukraine, etc.

I. PREPARE BUFFER FOR DECLINING RBC RATIO

In response to declining RBC ratios following interest rate hikes, the authorities will recognize inclusion of the LAT[8] (liability adequacy test) surplus[9] into the available

[1] The meeting was chaired by Secretary General Lee Se-Hoon and participated by the Financial Supervisory Service, CFOs of insurance companies, industry associations and market experts.
[2] RBC = available capital / required capital
[3] Liabilities to operating assets (as of end-Dec 2021): Life insurance (58.7%), non-life insurance (45.7%)
[4] KTB 10-yr yield: 2.25% (end-2021), 2.68% (end-Feb 2022), 3.24% (end-Apr), 3.33% (end-May, up 108bp)
[5] KRW-USD: 1,088 (Dec 2020), 1,190.5 (Dec 2021, up KRW102.5), 1,244.5 (Jun 3, 2022, up KRW54)
[6] Insurance businesses have high propensity for short-term forex hedging.
[7] Distressed asset ratio at 0.52% as of the end of December 2021
[8] Liability adequacy test: Additional reserve requirement for insurance liabilities which take into account the difference between the mark to market valuation and cost valuation of insurance liabilities put in place from 2011

capital for the calculation of RBC ratios. The current RBC system based on the difference between the mark to market valuation of assets and historical cost valuation of liabilities results in a decline in RBC ratios in times of rising interest rates as the new method only incorporates losses on valuation of assets into available capital. However, when applying this measure, reductions in insurance liabilities as a result of interest rate hikes are also incorporated as available capital, thereby providing a buffer to the decline in RBC ratios.

Insurers will be able to include (a) 40 percent of the LAT surplus to their available capital (b) within the limit of losses on valuation of bonds available for sale.

a) In times of interest rate fall, 40 percent of the LAT surplus reserve,[10] which represent an increase in insurance liabilities, is deducted from the available capital. Considering this, in times of interest rate hike, the incorporation of 40 percent of the LAT surplus amount will be recognized as an increase in the available capital.
b) As the key reason for recent drop in RBC ratios is mainly from losses on valuation of bonds available for sale which insurers maintain for the purpose of matching with their long-term insurance liabilities, counterbalancing for accounting purposes will be restricted to losses on valuation of bonds available for sale.[11]

When applying this buffer,[12] it is expected that insurance businesses will be able to stably maintain their financial soundness as the RBC ratios of some of the insurers that have recently seen a drop in their RBC ratios will be above 100 percent.

II. Strengthen Management over Exchange Rate Hike

In addition, the authorities discussed the need for closer monitoring over insurers' foreign exchange liquidity and alternative investments that are deemed to be at risk and more closely managing and supervising insurers to enable insurance businesses to adequately prepare for risks.

III. Ensure Basic Response Capacity through Soundness in Capital Structure

Participants shared the same view that insurers need to fundamentally enhance the soundness in their capital structures through capital increase in order to ensure the maintenance of a sufficient level of payment capabilities in response to deepening volatility in financial markets. For insurers that have been raising capital through

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in preparation for the implementation of IFRS 17.

[9] Insurance liability cost valuation – LAT valuation amount for insurance liability

[10] Additional reserve of the difference between the market valuation liabilities and cost valuation liabilities based on a liquidity adequacy test.

[11] a) Securities at fair value through profit or loss are not part of assets that can be included as the available capital because they are not assets for matching long-term insurance liabilities, but instead, their purpose is to make short-term profits through trading
b) Classified into (1) securities at fair value through profit or loss, (2) securities available for sale and (3) held-to-maturity securities. Currently, the mark to market valuation approach is applied to (1) and (2) while the cost valuation approach is applied to (3).

[12] As of March 2022

issuance of hybrid securities and subordinated bonds to maintain the RBC ratio requirement, their capital structures have turned vulnerable to changes in market variables such as the interest rate.

As the new capital adequacy regime (K-ICS or Korea Insurance Capital Standard) will come into force from 2023 that will allow more precise measurement on the risks of insurers,[13] the authorities will continue to perform weighted impact assessment on insurers and promote capital growth for those that have low capital adequacy levels through capital increase with consideration, etc.

FURTHER PLAN

It is expected that the RBC buffer will begin to apply from the calculation of RBC ratios for the end of June period after the issuance of a notice of rules change (from June 9 to 20) and an approval from the FSC. Moreover, the authorities plan to keep close monitoring of market situations and strengthen management and supervision to ensure that insurers maintain soundness despite unfavorable financial environments.

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For press inquiry, please contact Foreign Media Relations at fsc_media@korea.kr.

[13] Adoption of shock scenario method and an upward movement of risk confidence level (99.0% → 99.5%), etc.