

Taiwan: Insurance

Potential allowance of FX reserves could have positive implications

Insurance Bureau might allow FX reserves in place of actual hedges

Commercial Times (June 16) reported that the Insurance Bureau at the FSC could approve the proposal by the end of June, to allow insurers to take FX reserves on overseas investment portfolios in place of actual cross-currency hedges (similar to Japanese/Singapore insurers). We believe this would give life insurers greater flexibility and enhance the cost effectiveness in managing FX risk. According to Economic Daily (June 4), the FSC appears to support such an idea in principle, but could need further discussions with the Accounting R&D Foundation, as it could conflict with the IFRS standard of not having to MTM on positions—which the FSC had planned to launch in 2011 (stage 1).

Two major benefits: smooth out earnings and keep cash in-house

The major life insurers in Taiwan have c.30-35% of their investments in overseas assets as they seek higher investment yields, while most of their liabilities are denominated in NT\$. To hedge the currency risk, they adopt cross-currency swaps, non-delivery forwards and basket hedges, for which the hedging cost can range between 100-350bp, depending on market conditions, which creates huge earnings volatility for life insurers. If the proposal is approved, the insurers will be allowed to take a fixed percentage of reserve on overseas investment portfolios based on historical NT\$/US\$ volatility, and only realize the gain/loss when the overseas investment is unwound. The key benefits would be two-fold: (1) to smooth out life insurers' earnings; (2) to keep the cash flow in-house as opposed to paying external parties for actual hedges.

Positive for life insurers; Reiterate Buy on Cathay and Fubon

Our analysis indicates a 10bp hedging cost decrease would improve Cathay (2882.TW), ShinKong (2888.TW) and Fubon's (2881.TW) 2010E earnings by 2.6%, 4.1% and 1.0%. As the major insurers in TW are allowed to gradually increase their overseas investment, a more stabilized hedging cost should improve their investment yields and help reduce the magnitude of negative interest spread. We reiterate our Buy on Cathay and Fubon with 12m SOTP target prices of NT\$58 and NT\$34, respectively.

Risks

Continued appreciation of the NT\$, that could cause the insurers to take one-time reserves to fill the gap between reserves and FX loss.

SENSITIVITY ANALYSIS: 2010E EARNINGS IMPROVEMENT IF HEDGING COST DROPS BY 10BP

NT\$m	Cathay	ShinKong	Fubon & Antie Life
Overseas equity	31,400	33,930	1,700
Overseas fixed income	753,500	373,230	253,000
Total overseas investment	784,900	407,160	254,700
FHC net income in 2010E	23,831	8,030	19,533

Potential hedging cost decrease	10bps	10bps	10bps
Potential impact on earnings*	628	326	204
% of 2010E net income	2.63	4.06	1.04

Source: Company data, Goldman Sachs Research estimates

OUR STOCKS

Ticker	Rating	16-Jun Close	12-mo TP	P/B	09E	10E
		NT\$	NT\$	(X)	(X)	(X)
Cathay	2882.TW	Buy	45.6	58.0	2.3	2.0
Fubon	2881.TW	Buy	29.1	34.0	1.4	1.3
ShinKong	2888.TW	Sell	12.7	13.5	1.2	1.0

Valuation: we use SOTP valuation for Cathay, Fubon and ShinKong.

Downside risk: Sharp NT\$ appreciation; US economy double-dips. Upside risk: Stronger market sentiment supported by closer cross-strait relations.

RELATED RESEARCH

Cathay FHC (2882.TW): Pro-cyclical gearing off a solid franchise; upgrade to Buy (May 18, 2009)

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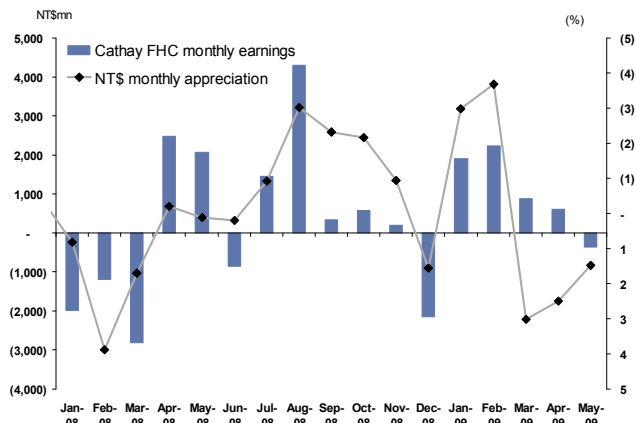
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Exhibit 1: The major insurers in Taiwan have 30-35% their investment portfolio in the overseas market

As of 1Q09 NT\$bn	Cathay			Shin Kong			Fubon		
	Amount	%	% of FHC's BV	Amount	%	% of FHC's BV	Amount	%	% of FHC's BV
Domestic equity	136	6%	0.9x	57	5%	1.0x	45	12%	0.3x
Domestic fixed income	327	15%	2.1x	305	27%	5.4x	171	46%	1.1x
Overseas equity	31	1%	0.2x	34	3%	0.6x	2	0%	0.0x
Overseas fixed income	754	34%	4.9x	373	33%	6.7x	111	30%	0.7x
Real-estate	126	6%	0.8x	79	7%	1.4x	14	4%	0.1x
Mortgage	339	15%	2.2x	68	6%	1.2x	12	3%	0.1x
Policy loan	196	9%	1.3x	113	10%	2.0x	8	2%	0.0x
Cash	261	12%	1.7x	102	9%	1.8x	10	3%	0.1x
Others	47	2%	0.3x						
Total	2,218	100%	14.4x	1,163	100%	19.9x	373	100%	2.4x

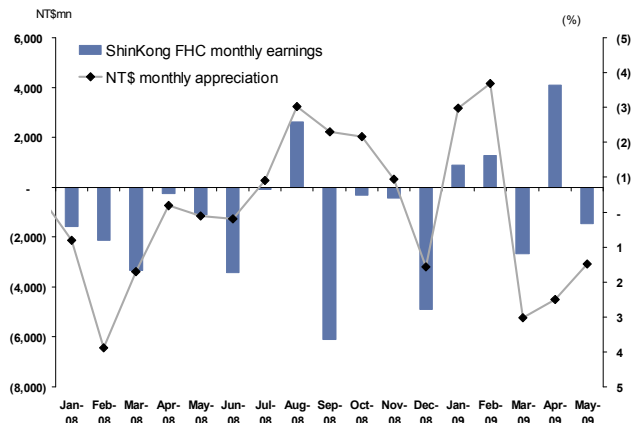
Source: Company data, Goldman Sachs Research.

Exhibit 2: Cathay's earnings have been volatile due to FX rate fluctuations



Source: Company data, Dtastream

Exhibit 3: ...as well as ShinKong's earnings



Source: Company data, Dtastream

Exhibit 4: Hedging method comparison

Method		MTM
Currency swap	Involving the exchange of a loan in one currency for a loan in another currency, both principal and interest are exchanged	Yes
Traditional hedge	NDF Taking the difference between the agreed upon exchange rate at the settlement date	Yes
Proxy hedge	Using a basket of different FCYs to hedge against the US\$, taking the risk the NT\$ appreciates more than other FCYs do	Yes
Natural hedge	No hedge, taking the risk of NT\$ appreciation	Yes
FX reserve	Providing reserve based on historical NT\$ volatility, taking the risk NT\$ does not follow historical trend and continue to appreciate	No

Source: Company data, Goldman Sachs Research.

Exhibit 5: Our sensitivity analysis indicates that Cathay, ShinKong and Fubon's 2010E earnings would improve by 2.6%, 4.1% and 1.0%, if hedging costs decrease by 10bp

NT\$bn	Cathay	ShinKong	Fubon & Antie Life
Overseas equity	31	34	2
Overseas fixed income	754	373	253
Total overseas investment	785	407	255
FHC net income in 2010E	24	8	20
Potential hedging cost decrease	10bps	10bps	10bps
Potential impact on earnings*	1	0	0
% of 2010E net income	2.63	4.06	1.04

* We assume 20% tax rate (Taiwan's corporate tax rate)

Source: Company data, Goldman Sachs Research estimates.

Reg AC

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