

Asia FI & FX Strategy Watch

Taiwan lifer update – December 2023

Lifers began adding to FX-hedges in 3Q23

FX-hedging ratio among the large Taiwanese life insurance companies (lifers) began to increase in 3Q23 despite the continued rise in spot USDTWD. This led to lifers taking advantage of cheaper FX-hedges as NDF points rose throughout 3Q23.

In 2024, we expect the lifers' FX-hedge ratio to further increase. This will likely especially be necessary should the decline in USDTWD accelerate beyond our base case. Our base case is for USDTWD to decline by 3.5% throughout 2024. However, this decline will not happen linearly and during periods of US\$ weakness, increased realized FX loss would prompt additional FX-hedging. As such, one of our 2024 Year Ahead trades is to receive 6x12 TWD NDF swap, to position for greater USDTWD forward selling by lifers (current: -642, entry: -672, target: -900, stop: -500, see: [here](#)). A risk to the trade is resumption of USD strength and lower FX-hedging by the lifers.

Limited upside for lifers as US rates rally

Historically, lifers relied on the inverse movement of US rates and the USD to partially offset the negative impact of USD weakness to operating income. 2022 was a record year of bond loss but this loss was offset by strong realized gains in USDTWD. 2023 was another strong year of USDTWD gains, offsetting the rise in US rates. In 2024, when US rates and USD begin to turn, the FX loss is unlikely to be offset by bond gains due to the large reclassification exercise which occurred throughout 2022. As such, if USD performs weaker than we currently expect, this could result in a rapid increase in FX-hedging by lifers to offset the negative impact of FX loss.

05 December 2023

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This report describes in detail how the changes in the international environment (mostly exposure to USD and US rates) can impact the lifers' operating income, operating cost and net profit. We would recommend readers to visit the link in the footnote¹ to see construction of the lifers' aggregate income statement and understand how different items impact their net profit in different ways.

The table below summarizes the comments the lifers provided in their 3Q23 filings on the topic of FX or FX-hedging.

Life insurance company	Commentary on FX and FX-hedging
Fubon Life	USD may go weaker in the near-term. Fubon will stay dynamic in hedging to leverage NDF, proxy hedging and FX reserve mechanism.
Cathay Life	Cathay restated that its FX reserves were sufficient to offset decline in USDTWD until November. Cathay will continue to use a dynamic hedging strategy to take advantage of prices in DF, NDF and proxies.
China Life	Expects hedging cost to stay similar or be slightly better in 2024.
Taiwan Life	Expects the cost of DF and NDF could be similar in 2024.

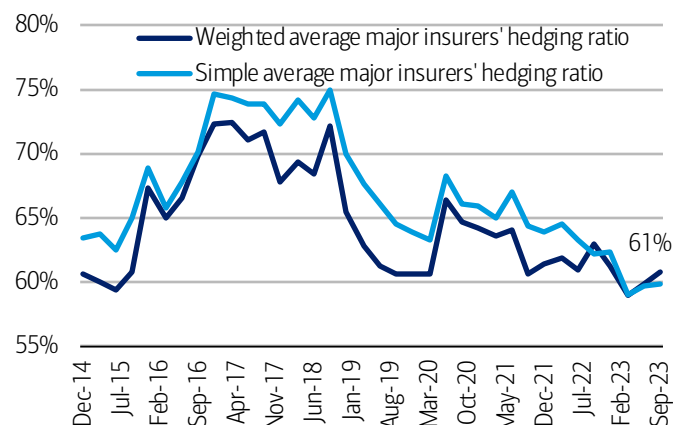
On FX-hedging:

- In 3Q23, we saw the FX-hedging ratio of the lifers increasing to 61%, from 60% in 2Q23 though USDTWD was on a general path of increase. This may be reflective of some of the lifers beginning to pre-hedge, taking advantage of the increase in NDF forward points.
- Up until October, FX-hedging cost for the lifers remained high. Year-to-date to October, reported FX-hedging cost was US\$9.2bn, almost three times the year-to-date value in 2022 and the highest year-to-date figure on record since data became available starting 2020.
 - The biggest share of lifers hedging comprised in the onshore DF swap, followed by NDF swap and a small minority in proxy hedging in other currencies such as USDKRW, USDCNH and USDSGD
- In November, with the peak US\$ and narrative for end of the Fed cycle, NDF points collapsed as spot USDTWD rapidly declined. Subsequent data on FX-hedging cost should increase.

¹ https://www.tii.org.tw/report_test/2030/PDF2030_2022.pdf

Exhibit 1: Lifers' FX-hedging ratio (%)

The FX-hedging ratio of lifers increased to 61% in 3Q23 (from 60% in 2Q23)

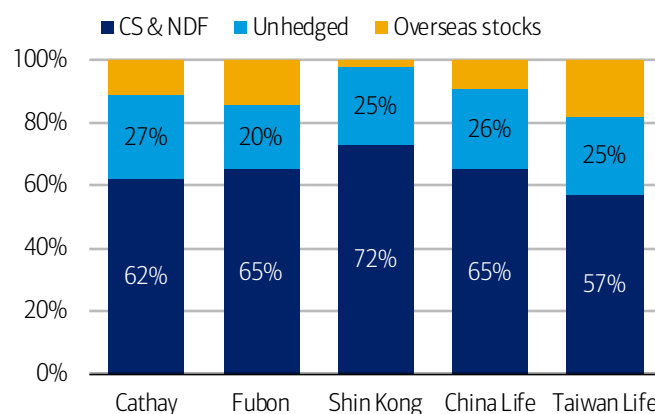


Source: Company filings

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Exhibit 2: 3Q23 breakdown of FX-hedging activity by lifer

The FX-hedging ratio varies from 57% to 72% among the five large lifers

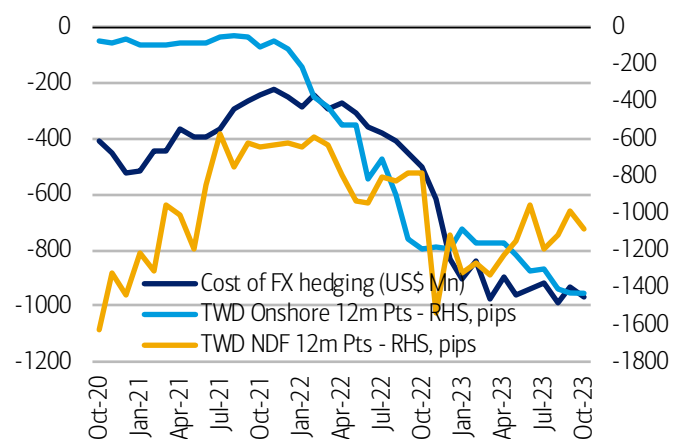


Source: Company filings

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Exhibit 3: Cost of FX-hedging and 12-month DF and NDF forward points

FX-hedging cost by the lifers is close to US\$ 1bn per month

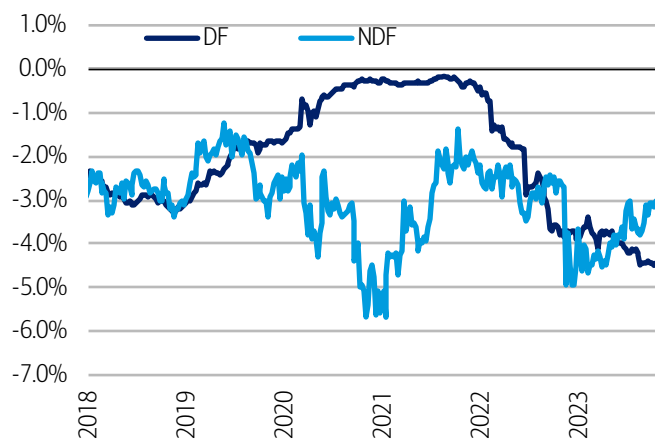


Source: CEIC, Bloomberg

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Exhibit 4: Annual cost of FX-hedging (selling USDTWD forward, %)

NDF points have aggressively turned lower as the US\$ turned in November 2023



Source: Bloomberg

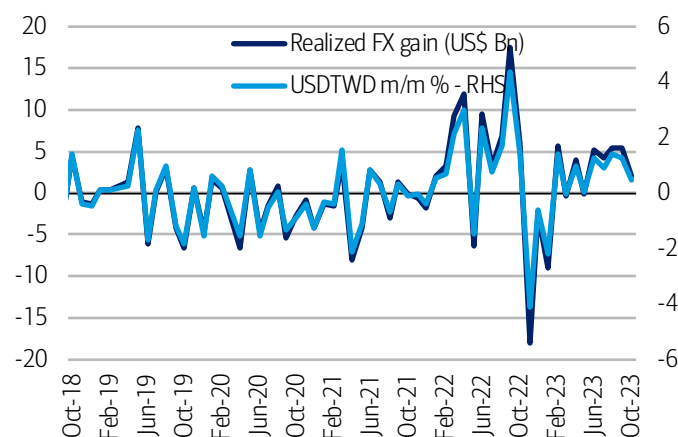
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On FX gains:

- **Exhibit 5** shows the tight link between realized FX gains and the monthly movement in USDTWD. Historically, a 1% increase in USDTWD results in a US\$4bn increase in realized FX gains.
- FX gains remain an important contributor of operating revenue for the lifers in 2023. Year-to-date to October, realized FX gains were close to US\$21bn and contributed to 26% of year-to-date operating revenue. This declined from US\$54bn in year-to-date to October 2022, which comprised 78% of operating revenue (**Exhibit 8**).
- Another item that helped increase operating revenue in 2023 is the flat-lining of FX valuation reserves. FX valuation reserves are used to smooth out FX volatilities: when USDTWD increases, historically, lifers have added to their FX valuation reserves to offset future FX loss. However, starting March 2023, the FSC permitted lifers to stop adding to their FX valuation reserves despite the meaningful increase in USDTWD (**Exhibit 7**). Lower FX valuation reserves directly contributes to higher operating revenue.

Exhibit 5: Realized FX gains and movement in USDTWD

Upward movement in USDTWD is directly passed on as FX gains

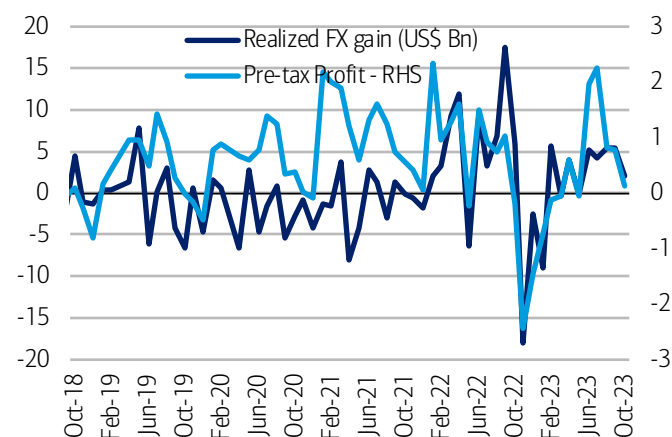


Source: CEIC

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Exhibit 6: Realized FX gains and pre-tax profit (US\$ Bn)

Large change in pre-tax profit is often driven by sharp moves in FX gain/ loss

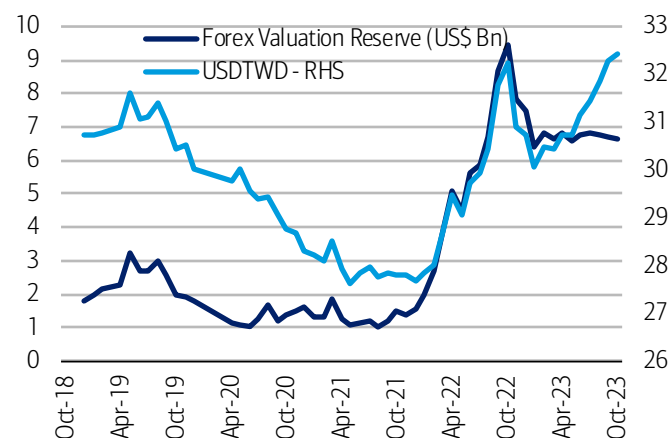


Source: CEIC

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Exhibit 7: FX Valuation Reserves (US\$ Bn)

FX valuation reserves have stalled despite the increase in USDTWD, resulting in higher operating revenue in 2023

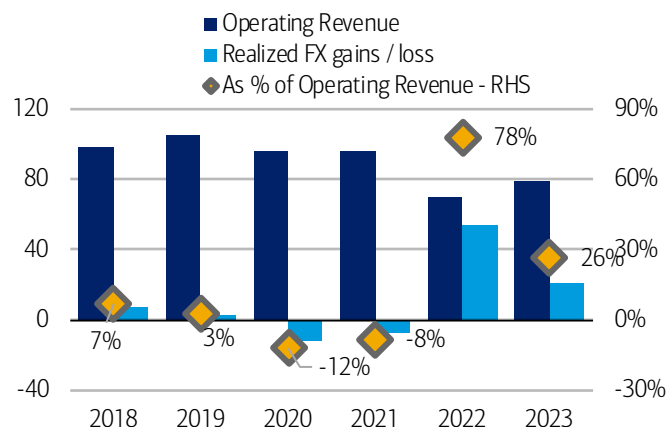


Source: CEIC

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Exhibit 8: Year-to-date operating revenue and realized FX gains/ loss (US\$ Bn)

In 2023, for the first 9 months, FX gains were responsible 26% of the total operating revenue



Source: CEIC, FSC

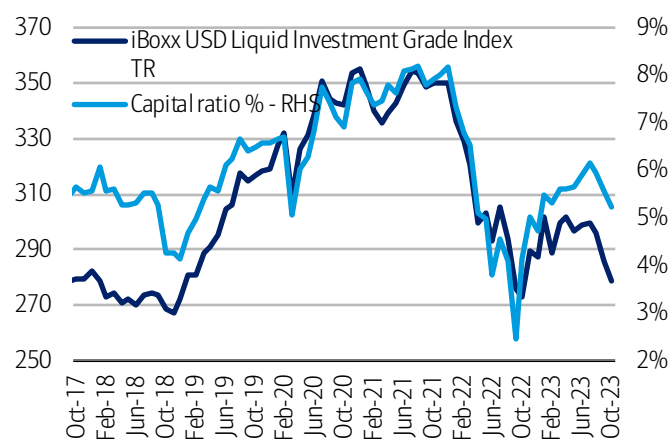
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On asset valuation, capital ratios and net change in asset

- The capital ratio of the lifers declined in October 2023 to 5.2%, down from a recent high of 62.2% in July 2023. The decline is tied to a real steepening of the US rates curve, resulting in lower IG bond valuation and equity losses, leading to a lower retained earnings and capital ratio (**Exhibit 9**).
- Despite the meaningful decline in US rates starting November 2023, the realized gains the lifers can recognize would be limited due to the large reclassification exercise the lifers conducted in 2022. Throughout 2022, the lifers significantly increased the portion of the bond holdings from fair value at other comprehensive income (FVOCI) to amortized cost (AC), see **Exhibit 11**.
- This reclassification allowed the lifers to reverse the year-to-date losses in their bond portfolio. In 2022, the lifers recouped close to US\$30bn in financial losses and significantly helped offset the realized financial losses elsewhere in their portfolio (**Exhibit 10**). Last year, reclassification gains were the second-highest positive contributor to their financial receipts, after the realized FX gains.
- In 2024, when we expect IG bonds to recover as the Fed begins to cut rates, the lifers would see limited benefit due to the small percentage of bonds held under FVOCI. Going forward with a US\$ weaker and limited capital gains from bonds in the FVOCI portfolio will result in the lifers seeking other sources of growth.

Exhibit 9: Return on US investment grade and lifers' capital ratio

The lifers' capital ratio declined in October 2023 as US rates sold-off

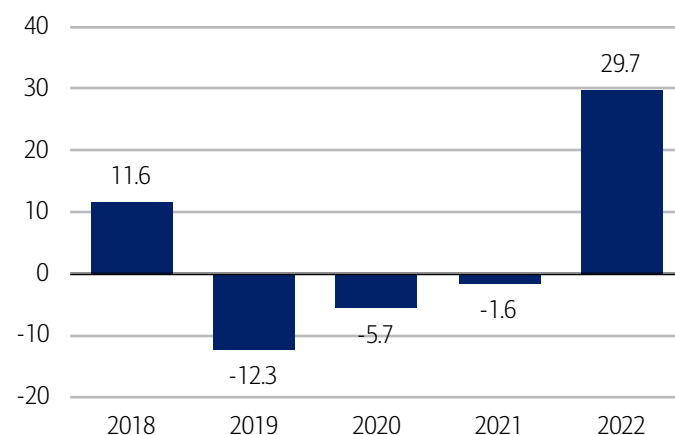


Source: Bloomberg

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Exhibit 10: Reclassification gains (US\$ Bn) by year

The largest reclassification gains from on 2022 will prevent the lifers from benefiting when US\$ rates rally

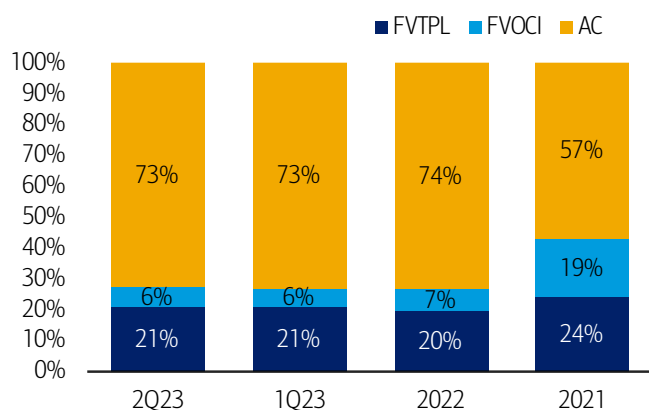


Source: FSC

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Exhibit 11: Classification of the lifers' assets

As of 2Q23, only 6% of the lifers' assets can benefit from a rally in US rates

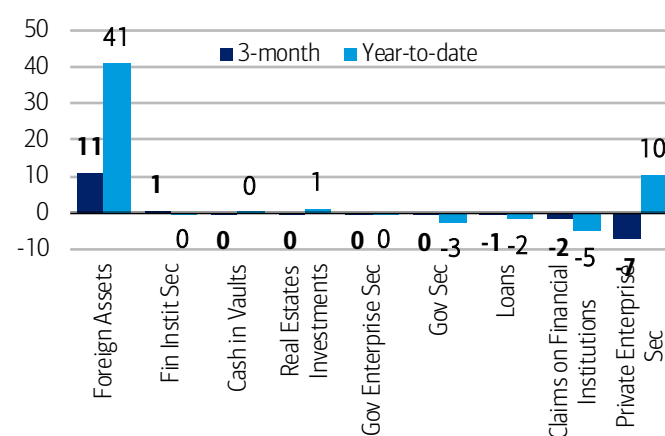


Source: Company filings

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Exhibit 12: Net change in the lifers assets: by asset class (US\$ Bn)

Year-to-date, the largest growth among the lifers are foreign assets and private enterprise securities

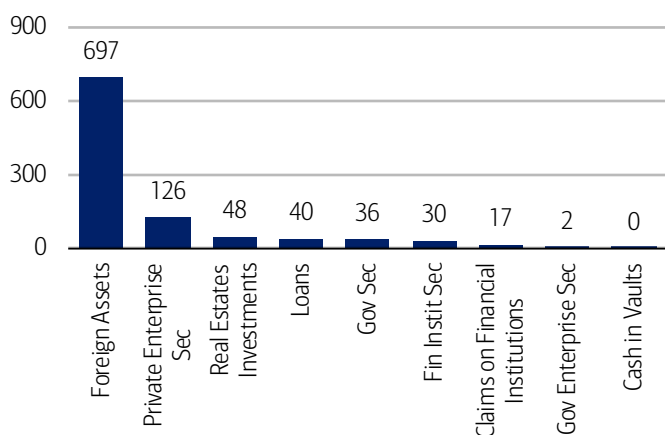


Source: CEIC

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Exhibit 13: Distribution of the lifers' asset: by asset class (US\$ Bn)

Foreign asset remains the single-largest asset class for the lifers



Source: CEIC

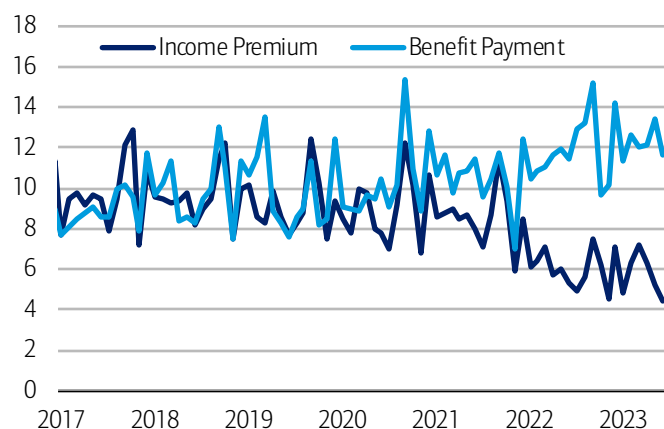
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On premium income, benefit payments and competition from FX deposits and bond ETFs:

- The structural problem with the lifers of reduced cash inflow (declining income premium) amid rising outflows (rising benefit payments) continues (**Exhibit 14**). In September 2023, the income premium across all major lines came in at US\$4.1bn, while benefit payment was US\$11.6bn.
- The sale of life plans continues to face competition from FX time deposits and bond ETFs. The level in FX time deposit remains elevated at US\$173bn but its growth rate has stalled with the pause in the Fed's hiking cycle.
- Net inflows into bond ETFs also appear to be slowing, with the November inflow at US\$1.2bn. **Exhibit 18** shows Taiwanese investors have typically chased higher yields in US IG and tend to slow their pace of investment when rates begin to decline. Year-to-date, we have observed around 2/3rd of the net inflows into bond ETFs, which were benchmarked against US IG, while 1/3rd were into funds benchmarked against US Treasuries.

Exhibit 14: Income premium and benefit payment (US\$ bn)

The gap between income premium and benefit payment continues to widen

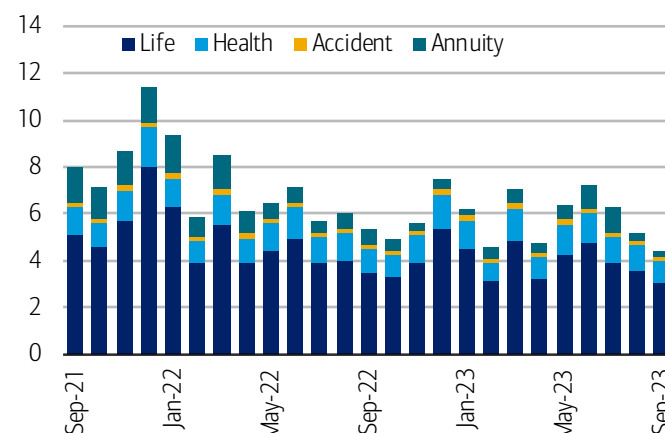


Source: CEIC

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Exhibit 15: Premium income: by group (US\$ Bn)

With the large decline in income premium from the sale of life insurance

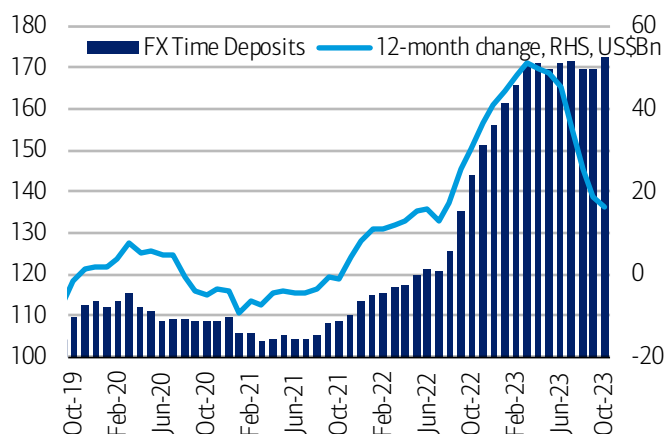


Source: CEIC

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Exhibit 16: FX Time Deposits (US\$ Bn)

The level in FX time deposits remains elevated but the pace of growth has slowed

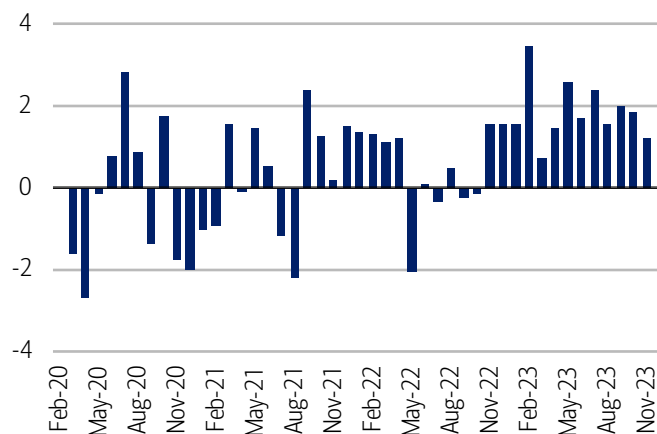


Source: CEIC

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Exhibit 18: Monthly net inflow into bond ETFs (US\$ Bn)

Lifers also face competition from inflows into bond ETFs but the pace has begun to slow

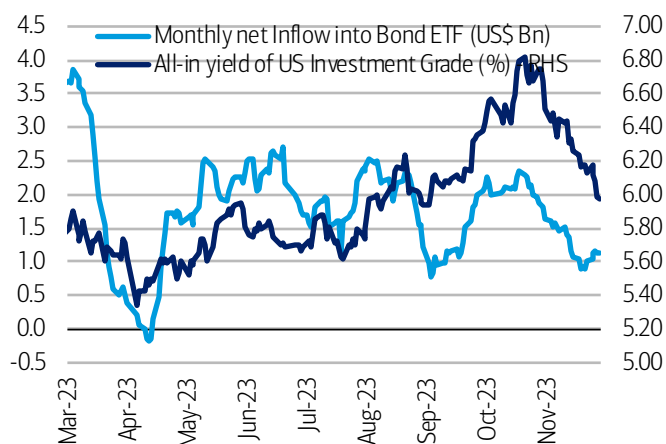


Source: Bloomberg

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Exhibit 17: US IG yield (%) and monthly inflow into bond ETFs

Monthly inflows into bond ETFs are slowing as all-yield yield of US IG begins to decline



Source: Bloomberg

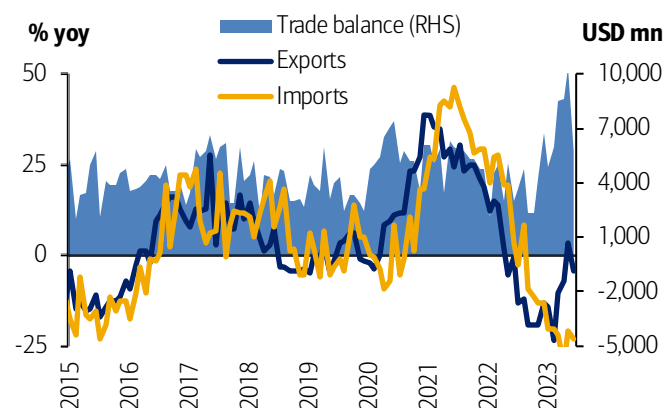
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On Macro:

- Taiwan's Oct CPI inflation rose unexpectedly to 3.05% yoy (vs. 2.93% in Sep), exceeding expectations. Core CPI inflation remained largely unchanged at 2.49% yoy. Similar to Aug-Sep, the higher CPI print was mainly driven by vegetable/fruit prices due to the impact of heavy rainfall, as well as sticky services prices. We estimate the average CPI inflation could end up higher at 2.5% in 2023, before moderating gradually to the CBC's implicit target of 2% by mid-2024.
- Taiwan's export growth moderated to -4.5% yoy in Oct (vs +3.4% in Sep) against a higher year-ago base, pointing to sluggish external demand despite the AI boost. Imports dropped by 12.3% yoy in Oct. Trade surplus declined notably to US\$5.8bn from a record level of US\$10.3bn in Sep. We expect a modest recovery in exports in 2024, as tech exports will likely improve on both structural and cyclical factors.
- We maintain our 2024 GDP growth forecast at 3.2% (vs. 1.1% in 2023), on a modest recovery in tech exports and capex demand. Key downside risks include weaker-than-expected demand in mainland China, the US and Europe, as well as geopolitical tensions (see [Taiwan YA report](#)).
- With the upside surprises in 3Q GDP data and Sep-Oct CPI prints, as well as the CBC governor's latest communications, we now expect the CBC to deliver one more 12.5bp hike at its upcoming meeting on December 14 (vs. no change previously). We expect the CBC to stay on hold throughout 2024–25.

Exhibit 19: Exports, imports and trade balance

Oct exports fell by 4.5% yoy; trade surplus fell notably to US\$5.8bn

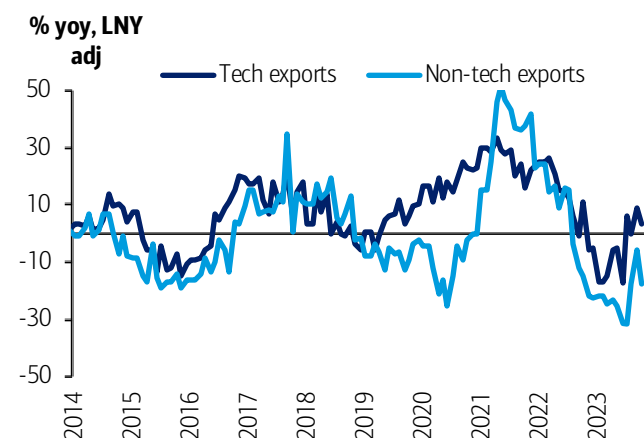


Source: BofA Global Research, CEIC

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Exhibit 20: Tech exports vs. non-tech exports

Tech export growth moderated in Oct

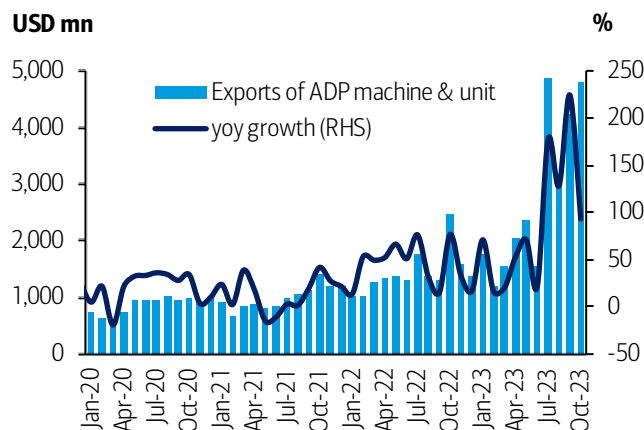


Source: BofA Global Research, CEIC

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Exhibit 21: Exports of ADP machines & units (monthly data)

Exports of ADP machines & units surged since July, likely driven by AI servers

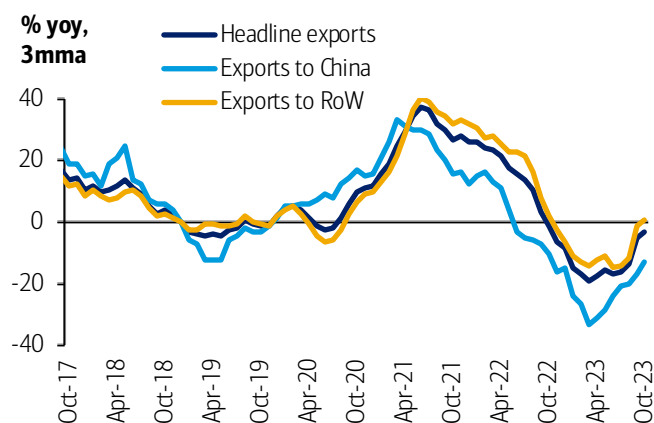


Source: BofA Global Research, CEIC

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Exhibit 22: Taiwan's exports: breakdown by destination

Shipment to China witnessed a smaller yoy contraction

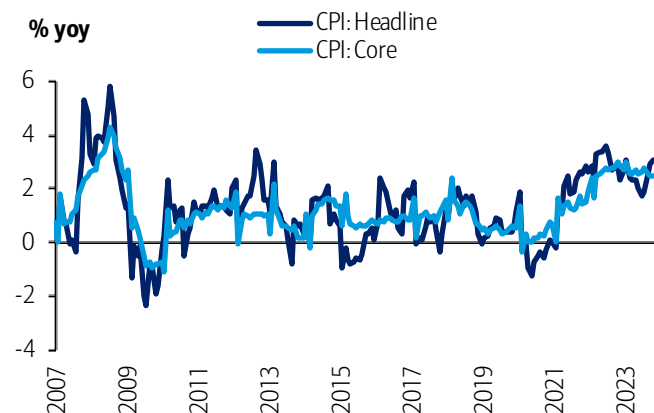


Source: BofA Global Research, CEIC

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Exhibit 23: Headline CPI vs. Core CPI

Headline CPI inflation rose unexpectedly to 3.05% yoy in Oct (vs. 2.93% in Sep), while core CPI inflation stayed largely unchanged at 2.49%

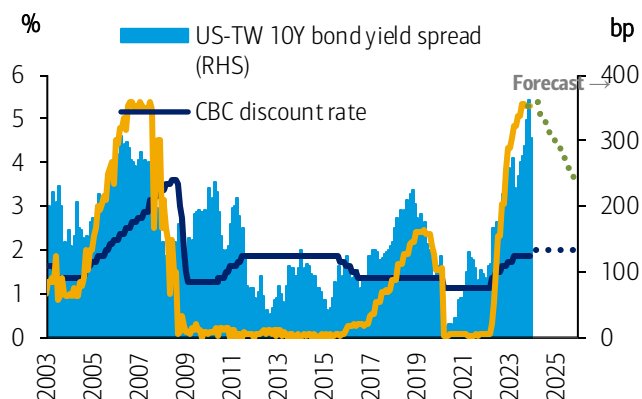


Source: BofA Global Research, CEIC

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Exhibit 24: CBC discount rate, Fed funds rate & US-TW 10y yield spread

We expect the CBC to stay on hold after one last 12.5bp hike in December

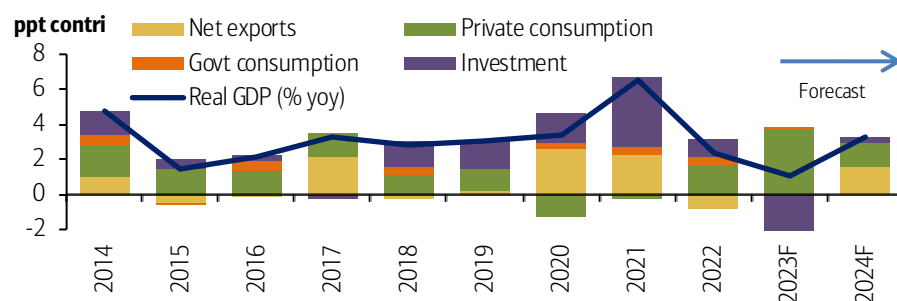


Source: CEIC, Bloomberg

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Exhibit 25: GDP growth by expenditure

We expect GDP growth to rebound to 3.2% in 2024 on a modest recovery in exports as tech cycle turns



Source: BofA Global Research estimates, CEIC

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