Daiwa Securities

# Daiwa's View

## FY22 results at life insurers

➢ Increased use of options amid falling hedge ratio

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### FY22 results at life insurers

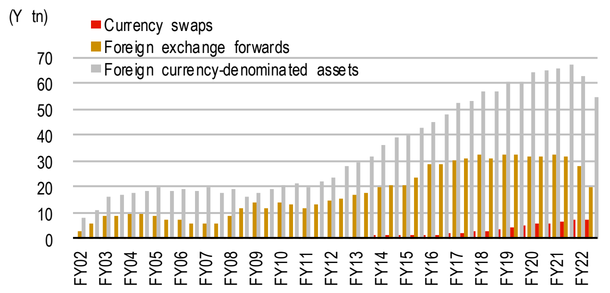
**Increased use of options amid falling hedge ratio**

Life insurers announced their FY22 results. In 2H FY22, their holdings of foreign currency-denominated assets continued to decrease, as in 1H, and the level was the lowest since FY17 (Chart 1). Foreign bonds appear to have been sold while hedging costs for investment in foreign bonds remained high. This is consistent with the statistics for outward investment in securities.

In addition, life insurers appear to have lowered their currency hedge ratio further from the level in 1H FY22 (Chart 2). This is a natural trend because (1) yield curves of overseas yields remain roughly flat (Chart 3 on next page) and (2) the yield difference between JGBs and hedged foreign bonds has reached a record level due to a rise in hedging costs for Japanese financial institutions.

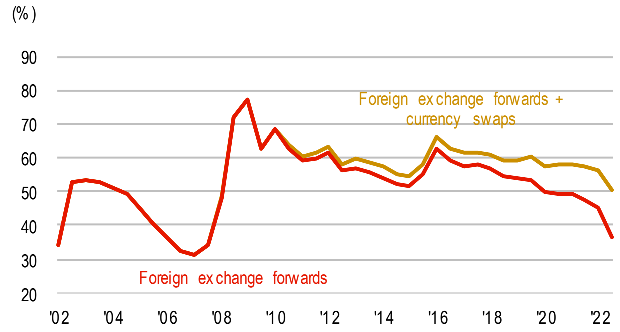
Owing to the bank shock in the US and Europe in March, the market's pricing in of rate hikes temporarily diminished and pricing in of rate cuts increased, which led to the unwinding of curve flattening. However, the curves are currently back to the flattening trend due to the firmness of US economic indicators and the resolution of the US debt ceiling issue. Until they are certain inflation will decline toward their targets, overseas central banks intend to maintain their policy interest rates at high levels. Thus, hedging costs are expected to remain high and the hedge ratio at life insurers is also likely to stay at low levels for the time being.

**Chart 1: Holdings of Foreign Securities and Currency Hedging by Major Life Insurers**




*Source: Earning results materials at major life insurers; compiled by Daiwa Securities.*

**Chart 2: Currency Hedge Ratio at Major Life Insurers**




*Source: Earning results materials at major life insurers; compiled by Daiwa Securities.*

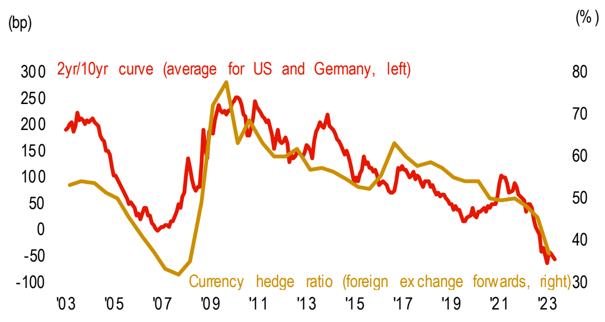
However, as shown by a continuous increase in the amount of currency swaps, the hedge ratio that is calculated from figures including currency swaps has not declined so much. This appears to be influenced by the positive stance of investing in credit products. In fact, investment plans from 2H FY22 to FY23 (refer to our 2 May 2023 report *FY23 investment plans at life insurers*), showed the positive stance of investing in credit products in order to cope with hedging costs, which are hovering at high levels.

In the latest results, it is notable that holdings of currency options increased remarkably, separately from the holdings of foreign exchange forwards and currency swaps (Chart 4). We presume that life insurers increased investment in unhedged foreign bonds as well as tried to hedge extreme currency fluctuations (risk of yen appreciation) while hedging costs remained high for foreign exchange forwards and currency swaps. The financial results show that not all life insurers reported an increase in transactions of currency options. In addition, at life insurers reporting increases in option transactions there are two patterns—(1) buying only put options (selling of foreign currencies) and (2) combining purchases of put options and selling of call options (buying of foreign currencies).

Under transactions involving buying only put options, yen appreciation risk is hedged above a certain level by paying option premiums. Meanwhile, under transactions that combine purchases of put options and selling of call options, life insurers appear to be saving option premiums even if it means abandoning more than a certain level of merit from the yen depreciation, while still hedging yen appreciation risk above a certain level. Both transactions would limit losses from unhedged foreign bonds in the case of extreme appreciation of the yen. Of course, option holders incur losses due to yen appreciation in the range between the currency rate levels at time of purchases of unhedged foreign bonds and the strike price of put options. Therefore, currency risk cannot be completely eliminated. However, under the situation where hedging costs are very high, like now, this approach is one option for balancing yield hunting and risk of yen appreciation.

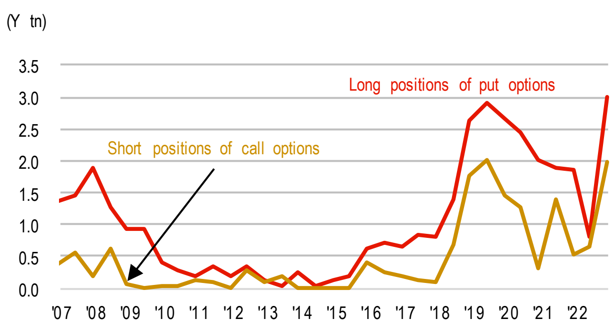
Currently, only some of the life insurers are actively using currency options. However, the usage of option transactions may now increase while hedging costs remain high. We think that this is a natural trend, given the fact that some life insurers have an aggressive stance for investment in unhedged foreign bonds, as shown by the FY23 investment plans. In addition, the USD/JPY rate is expected to be solid in the near term due to the firmness of the US economy, which will also lend support. Moreover, aggressive investment in unhedged foreign bonds means an increase in purchases of the dollar (foreign currencies) by life insurers, serving as a factor in making the USD/JPY rate solid in a self-fulfilling manner. As the extent of rise in US yields is not expected to be large from now, the USD/JPY rate is unlikely to rise rapidly. However, the aforementioned aggressive stance is likely to bolster the USD/JPY rate amid a lack of particular market factors.

**Chart 3:Yield Curve in US and Germany, Currency Hedge Ratio**




*Source: Bloomberg, earning results materials at major life insurers; compiled by Daiwa Securities.*

**Chart 4: Holdings of Currency Options at Major Life Insurers**




*Source: Earning results materials at major life insurers; compiled by Daiwa Securities.*

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