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Currency Risk Management for Hong Kong Insurers: prepare for the next unpeg

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Because of the currency peg system, the exchange rate move between 7.75 and 7.85, a pretty narrow range. Hence, so far, the FX mismatch risk is very well contained.

The Swiss franc peg was introduced in 2011 in response to investors buying up substantial amount of the currency as a safe haven asset. On Jan. 14, 2015, the Swiss franc was trading around 1.2, at the minimum exchange rate of 1.20 francs to the euro cap. On Jan. 15, with no hints from the central bank, the Swiss government announced the removal of the three year old Swiss franc to euro ceiling policy. The euro dropped as low as to 30 percent against franc, plunged to 0.85 francs per euro at one point. The central bank also cut its main interest rate to -0.75 percent—a move further into negative interest territory.

The sudden death of the Swiss franc ceiling policy demonstrates the kind of currency volatility and impact when a currency peg is removed. The market, then, turns the discussion to the other fixed exchange rates system—Hong Kong's 32-year old peg with U.S. dollar.

THE HISTORY

In 1982, the negotiation between China and the United Kingdom over Hong Kong's sovereignty spurred huge capital outflows and drove consumer confidence down. The collection of events eventually resulted in "Black Saturday," when the Hong Kong dollar exchange rate was at an all-time low. In response to the currency crisis, Hong Kong abandoned the floating exchange rate system since 1974, and pegged its currency against the U.S. dollar at a fixed rate of HKD7.80 to USD1.

In 2005, Hong Kong committed to limiting the currency's decline to HK$7.85 per dollar and capping gains at HK$7.75. On several occasions, the rate has moved towards the lower limit of 7.75 before the Authority intervened, purchasing tens of billions in foreign currency in order to adjust the rate accordingly.

This system has been quite successful in stabilizing the currency and establishing the city's financial credibility. Hong Kong's economic achievements are impressive. The continuous stream of capital inflow has made Hong Kong an international business, trade and financial hub.

32 years had passed. On the other hand, increasing evidence suggests that the currency peg also contributes to underlying social, economic and political conflicts in Hong Kong. Many analysts are now speculating as to should the HKD be de-pegged.

THE INSURANCE INDUSTRY UNDER THE CURRENCY PEG

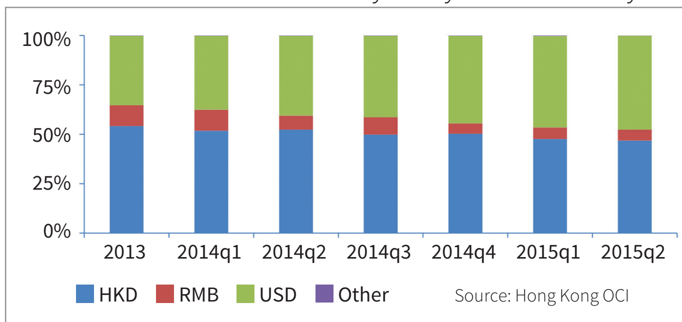
The insurance industry in Hong Kong has a long history of 170 years. There are over 150 authorized insurers. In 2014, the total gross premiums of the Hong Kong insurance industry increased by 13.3 percent to HK$339 billion. If the currency peg is removed suddenly, there would possibly be material impact on the industry.

The liability side

Individual life insurance, mainly participating business, is the dominant line of long-term insurance business, making up over 90 percent of the total business. In general, the long-term business has a liability-duration around 15-20 years. Under the current low interest rate environment, companies are facing the challenge of lengthened liability duration and a low investment yield.

Insurance benefits, as a result from its multi-currency capital market development, are issued in different currencies, particularly in HKD, USD, and RMB. Based on the recent Hong Kong OCI statistics, USD issued policies has gradually gaining momentum. It replaced HKD and became the most issued policy currency in Q2 2015.

Figure 1
Hong Kong Long-Term Insurance Direct Individual New Business Annualized Premiums by Policy Issued Currency

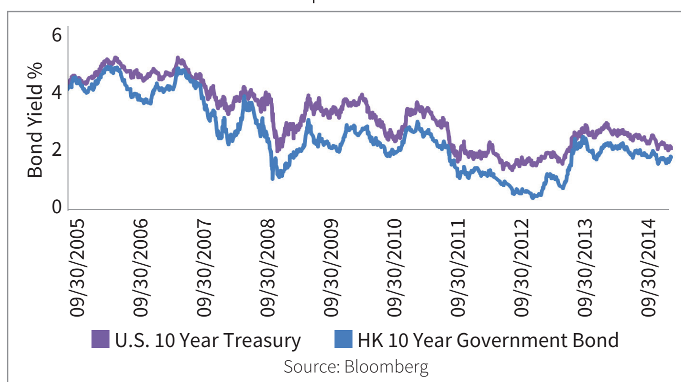


The investment side: fixed income market
Hong Kong's debt market is relatively small compared to its equity markets. Eighty percent of the bonds issued and traded are in OTC markets. The Government Bond Program was implemented in 2009. Twelve issues of institutional bonds totaling HK$66.5 billion and three issues of inflation-linked retail bonds totaling HK$30 billion were outstanding at the end of 2014. As a result, the Hong Kong debt market is still facing the reality of limited availability, illiquid, lack of long-term maturity products and relatively high credit risk. Under such environment, insurance companies have difficulties to look for perfect match HKD long-term assets to back their liabilities.

One alternative for insurance companies is to buy USD fixed income assets. There are high quality USD fixed income assets with long maturity, sound credit rate, higher yield in a more efficient and liquid markets. It is within the industry norm that life insurance companies have over 70 percent of their fixed income asset invested in the USD nowadays. However, this comes with a currency mismatch problem which has been kind of ignored as HKD is pegged with USD.

The ALM and currency mismatch
Hong Kong's interest rate has been at the 2 percent neighborhood in the past eight years, but U.S. fixed income still offers over 2-3 percent yield. Invested in the U.S. asset essentially increases the yield for the par business and becomes market practice.

Figure 2
10 Year Interest Rate Comparison: U.S. and HK



Source: Bloomberg

In the insurance industry, roughly around 50 percent of liability is denominated in HKD, while over 70 percent of asset is in the USD, i.e., part of the HKD liability is backed by USD asset. Because of the currency peg system, the exchange rate move between 7.75 and 7.85, a pretty narrow range. Hence, so far, the FX mismatch risk is very well contained. While some insurers choose to set up the currency hedging program, others embed the risk with more prudent provisions. The current regulation has not factored in such risk in the capital requirement.

IS IT TIME TO RE-PEG?

When the peg was first introduced, the United States was a key trading partner of Hong Kong. The HK economy was experiencing a tremendous GDP growth at about 9 percent. Nowadays, China has become the top trading partner. Hong Kong's economy growth has slowed down and the interest rate has decreased below 2 percent.

For a number of years, any calls for Hong Kong to unpeg to the USD were deflected with a single word: stability. One of the Hong Kong Monetary Authority (HKMA)'s primary objectives is to ensure the stability of the currency. On several occasions, the exchange rate has moved towards the lower limit of 7.75 before the Authority intervened, purchasing tens of billions in foreign currency to maintain the exchange rate. Hong Kong's exchange fund has become one of the world's largest official reserves, reaching an all-time high of US$345 billion in September 2015.

Many analysts are currently speculating as to when the HKD will be de-pegged, either at a lower USD rate, or even to the Chinese RMB or perhaps a basket of currencies. However, it is not only an economic or finance issue, but also political considerations have to be balanced.

The business environment
Increasing evidence suggests that the currency peg contributes to underlying social, economic and political conflicts in Hong Kong.

The USD has undergone a period of weakness after financial crisis, which has led to a high cost of Hong Kong imports, particularly in the critical food sector, given that Hong Kong imports 90 percent of its food. The city's consumer prices increased 3.3 percent in 2015 year over year, after increasing by 4.4 percent in 2014. The inability to adjust interest rates due to the peg also leads to upward pressure in all kinds of commodities, especially in the property market.

Also, Hong Kong's weak currency has a particular magnified impact next to the stronger RMB as integration with the mainland has accelerated in recent years. The depressed local currency was supercharging the huge arrival of mainland visitors and pressuring local prices upwards.

The capital markets
For decades, the United States had been the largest domestic export destination of Hong Kong. Starting from 2003—after the conclusion of CEPA—mainland and Hong Kong broadened the economic cooperation of the two sides, expanding market and facilitating trade and investment. And since 2005, mainland had replaced the United States to become the largest destination of Hong Kong's domestic exports—an average 36 percent. Also, in

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the past decade, mainland became Hong Kong's largest destination of re-exports and supplier of imports.

Early this year, hot money from mainland then pushed the Hong Kong stock market with average daily turnover to triple the usual amounts. Chinese investors twice used up their daily quota purchasing Hong Kong equities within one week in April through the stock connect. The strong inflow of southbound funds, make the 32-year peg under pressure. The monetary authority has to spend its reserve to defend the peg.

Furthermore, since the Hong Kong dollar is pegged, its monetary policy follows the United States involuntarily. HKMA has been forced to match ultra-low U.S. interest rates, even at the expense of a high inflation rate, and Hong Kong property prices have increased dramatically as a result. The unaffordable property and widening income inequality has becoming a wider problem of the new Hong Kong generation.

THE CHALLENGES AND RISKS

Peg and re-peg is like a double-edged sword. As the environment changes overtime, such fixed pegs contribute to so many problems mentioned above. But re-pegging is not an easy move neither. This may create more problems than it solves.

Financial and political

Despite being the one of the world's most-traded currencies, HKD is not especially tradable because of the peg. Economists say it is better to let it float. Once de-pegged, the HKD might temporarily lose value if the HKMA lags behind the Federal Reserve in terms of matching interest rates. However, as discussed above, there are also strong storylines for the HKD to appreciate as a result.

And the issue is more than just economics. Both China and Hong Kong are eager to maintain stability in Hong Kong. HKMA firmly believes changing the peg would hurt investor confidence, which could trigger catastrophic capital outflow.

Let's consider if re-pegging of the HKD becomes a possibility, what would the alternatives be? Some possible outcomes would be:

- Adapt a free float system
- Re-peg to a basket of currencies (like the Singapore currency board system)
- Re-peg to the Chinese RMB
- Revalue the USD peg to an appropriate level

But it's too early to draw such conclusions. The Hong Kong economy is too small to adapt to a free float system. To revalue the peg to another level may only be able to reduce but not solve the current problems. Re-pegging to a basket of currency also has many challenges, especially the transparency in how such a basket is defined. There are chances the basket also deviates from the fundamentals of the Hong Kong economy, etc.

As a matter of fact, there are many benefits from China's economic growth in the past two decades. Hong Kong is a well-known launching pad for international firms seeking to enter or exit the Chinese mainland, and its fortunes are increasingly related to those of China. Bankers and analysts in general believe the only reason for the Hong Kong dollar to re-peg would be to peg itself to the RMB. However, a peg with the RMB will not happen in the near future as the currency is not yet freely convertible. The inclusion of the RMB in the IMF's Special Drawing Rights basket could be seen as a favorable signal on that direction. Even if this happens one day, there are still other technical problems. For example, over the last few years, the RMB has appreciated against USD. If the HKD were to be re-pegged to the RMB, it would need more than 2 trillion RMB assets to replace the HKMA's US$345 billion foreign reserves, which exceeds the amount of current RMB assets in Hong Kong's offshore market.

Impact on insurance industry from risk perspective

With regard to the implications for the average Hong Kong life insurers, the effects of a revaluation of the currency are both short-term and long-term.

Predicted by Bill Ackman in his 2011 presentation, the HKD may experience a 30 percent appreciation if re-pegged. Under a 30 percent appreciation, the currency volatility spike up, immediately followed by a downward pressed interest rate movement. This leaves a large hole for ALM managers to fill.

As part of liabilities are backed by USD asset, when HKD appreciates, there will be an immediate material loss if FX risk is not properly hedged. Even with proper FX hedge and no immediate financial impact, the future yield movement will become more volatile and very difficult to manage volatility and substantially increased cost of hedging. When the U.S. / HK spreads widen or the HK yield drops, decreases in valuation interest rates and investment returns should not be a surprise. And this, in return,

impacts the financial where higher reserve and risk capital are required. The pressure can be amplified for those products with substantial guaranteed features.

In regards to the in-force participating business, the companies may not have choice but to lower dividends/crediting rates. This may trigger massive lapse that heighten liquidity risk within a short timeframe. For new money and new business, competition is also heightened, companies are looking harder for ways to enhance yield or de-risk the product by innovative product design.

Risk mitigation

To deal with this coming problem, several areas need attention and action immediately:

In-force business requires a detail sensitivity analysis on FX risk. Scenarios such as 20–30 percent devaluation in either currency plus 50–150 bps lower future investment return could be tested. Sensitive blocks of business should then be identified and potential remedies considered versus long-term objectives. Remedies can vary, depending on company financial strength and objectives. They could consider reinsurance arrangement, matching FX and future yield with derivatives, and to certain extremes, cutting future dividend for participating business, etc.

For new business, business strategy would be affected not only limited to the currency mix of production, but also to the extent of efficient deployment of risk capital. Basically, effort is required to drive for proper mix of currencies from new business. This mix should be derived from the expected investment in turns of currency. In case there is still a gap, appropriate allowance for the future FX volatility, yield gap and heightened risk capital requirement should be factored in the pricing process. Lower the product guaranteed, as well, to make the product more transparent to policyholder would also reduce any surprise and dispute in the future.

From the investment side, looking for ways to enhance yield is one basic thing all companies are doing. Including consideration of FX mix would make the investment process more comprehensive. Government should also assist the industry by promoting the development of a deeper local bond market.

CLOSING REMARKS

While the peg is still an integral part of Hong Kong's economy and daily life, China's RMB is not fully convertible, economists believe that re-pegging would probably not occur within the near future. But the clock for the risk managers in the insurance firm is ticking. ■

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