Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief May 24 - May 30

Japanese P&C insurers could face leaner days ahead

by KHAW Ker Wei

On 14 April 2016, a magnitude-6.5 earthquake struck the Kumamoto Prefecture in Kyushu, Japan. What was initially thought as an isolated tremor soon turned out to be a series of quakes when the main shock hit just less than two days later with a magnitude of 7.3. The quakes claimed a total of 49 lives and left thousands with injuries. Tens of thousands of people were estimated to have been displaced, after the orders were given to evacuate to emergency shelters. By May 2016, the insurance claims payout from the disasters had surpassed JPY 181bn, making it the second costliest, after the 2011 Tohoku quake.

The earthquakes occurred just as Corporate Japan was heading into a new fiscal year. Even before the disasters happened, the RMI-CRI 1-year Probability of Default (PD) for Japanese non-life insurers was already climbing towards a 2-year high. From just 5bps at the beginning of the second half of 2015, the aggregate PD (represented by the average PD) for the three major Property and Casualty (P&C) insurance companies – Tokio Marine Holdings, MS&AD Insurance Group Holdings and Sompo Japan Nipponkoa Holdings, rose to 29.7bps as of 27 May 2016 (see Figure 1). The higher reading on the credit risk measure underscored the weakness in the wider Japanese equity market. On a year-on-year basis, the Tokyo Stock Price Index was down by 20%, following a year of benign economic growth riddled with the impact of the currency and economic policies of China and the US. The earthquakes, while not as damaging as the 2011 disaster, would further set the profitability of the non-life insurers on the back-foot and maintain upward pressure on the PD for fiscal year 2016.

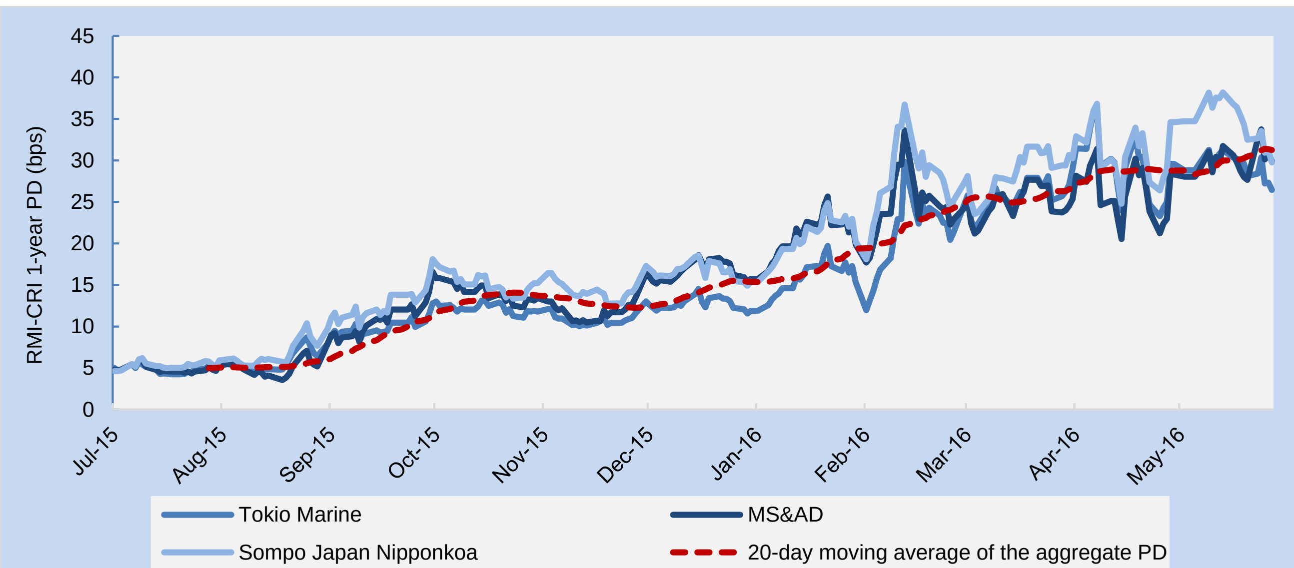

Figure 1: RMI-CRI 1-year PD for Tokio Marine, MS&AD and Sompo Japan Nipponkoa, as well as the 20-day moving average of the aggregate PD of the three companies *Source: RMI-CRI*

The payout for residential insurance related to the earthquake is not expected to threaten the financial strength of these companies, thanks to the Japan Earthquake Reinsurance system (see Figure 2) introduced by the Japanese government. Without the scheme, insurers' exposure to dwelling risks from earthquakes would have been too great, and can only be made possible with pricey premiums. Under the reinsurance scheme, non-life insurance companies are only liable to pay a maximum of JPY 36.7bn in claims, if the total damage exceeds JPY 100bn. The remaining liabilities resulting from a disaster will be shouldered by the government and the Japan Earthquake Reinsurance Company (JER), an entity set up by law to provide earthquake reinsurance services to non-life insurers. Furthermore, the reinsurance scheme works on a "no loss no profit" basis, which requires the earned premium to be capitalized as earthquake reserves on the balance sheet. Insured losses will therefore, only be offset by the drawdown of the reserves.

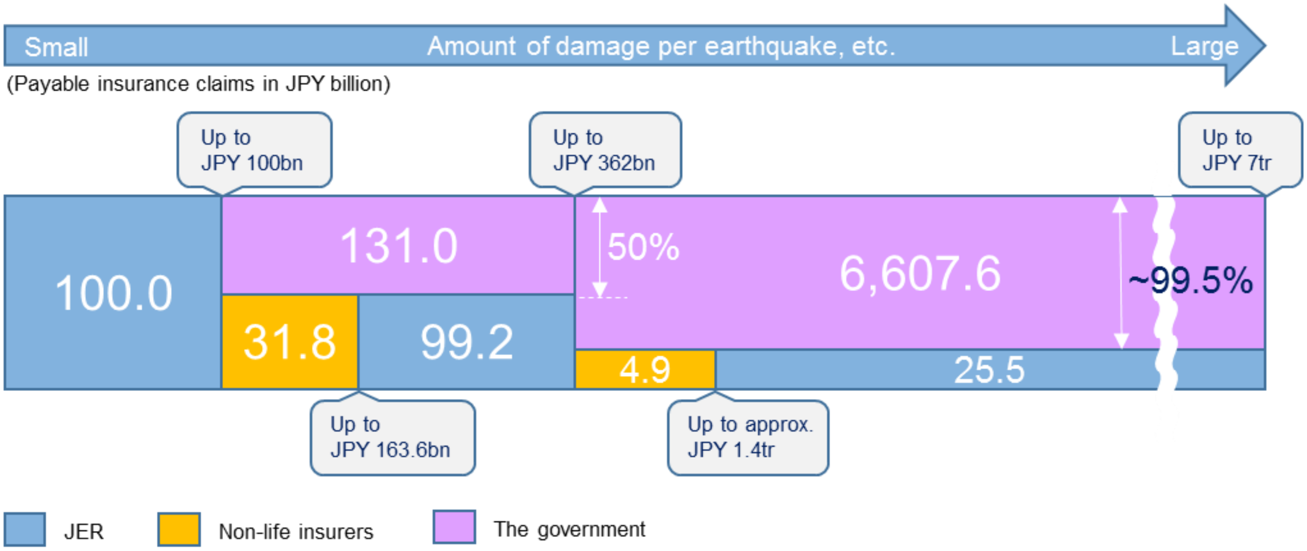

Figure 2: Reinsurance Scheme (applicable to earthquake, etc. that take place after 1 April 2014) *Source: Japan Earthquake Reinsurance*

Beyond residential earthquake exposure, which is limited due to government support, P&C insurers are also exposed to liabilities from underwriting commercial properties. Already, the Japanese insurers have estimated their losses from the earthquake, excluding residential coverage, with MS&AD expecting as high as JPY 12bn in payout, followed by Tokio Marine at JPY 5bn and Sompo Japan Nipponkoa at JPY 2bn. Despite the projected losses, all three insurers have affirmed their positive profit guidance for the upcoming fiscal year. Sompo Japan Nipponkoa estimates its net losses from natural disasters at only JPY 43bn for the full FY2016, among the lowest in recent years. In comparison, the company raked up JPY 111.7bn in losses in FY2013, mostly due to the worst snowstorm in decades in February 2014.

In coping with disaster claims, asset liability management for P&C insurers in Japan has also grown increasingly challenging. Low interest rates, to the point of breaching negative territories, look poised to stay as the Prime Minister prepares further stimulus to revive the ailing economy. Additionally, with little growth in the home market, the insurers have no choice but to venture overseas in search of yield. In 2015, Tokio Marine paid USD 7.5bn to acquire a specialty P&C insurer in the US, the biggest acquisition ever by a Japanese insurer. By doing so, Tokio Marine will not only be able to expand its business footprint, it will also be able to spread its risk geographically by offsetting the profits generated outside Japan to pay for disaster damages at home.

Japanese P&C insurers appear to have emerged from the most recent earthquake largely unscathed financially, due in part to prudent underwriting and the employment of effective reinsurance schemes. Although the catastrophe risk management practices are already stronger since the Great East Japan Earthquake in 2011, the uncertainties surrounding natural disasters would call for constant vigilance. The Japanese government issued a guidance in 2015, to increase the premium required for the earthquake rider of fire insurance by 20-30% in a gradual manner. The increase was advised after a panel of experts recalculated the probability of a major earthquake hitting Tokyo in the next 30 years, raising the odds from 26% to 46%. The country may not be able to prevent natural disasters from happening, but with a purposeful approach, it will still be able to ensure that funds are available to the people at a time when they are most needed.

Credit News

China default chain reaction threatens products worth 35% of GDP

May 30. China's default chain reaction posed a risk to the CNY 23.5tn worth of wealth management products (WMPs). This was a result of increasing cross-investment among the WMPs and increasing layered liabilities built upon the same underlying assets. This would create uncertainty about who is more vulnerable when there is a widespread loss, an analogy of the cause of the 2008 crisis. WMPs were the largest investors of Chinese corporate bonds. The concerns became more pressing this year when at least 10 Chinese companies defaulted on onshore bonds, the Shanghai Composite Index fell by 20% and China's slowest recovery in a quarter century. An analyst said there was a duration mismatch between WMPs and bonds. When investors were reluctant to roll over the debt, a liquidity crunch in the banking system may follow suit. (Bloomberg)

Bankruptcy in sight for South Korean shipbuilders

May 30. Korea shipbuilders were struggling with debt as a result of weak global trade and Korea's very trade-exposed nature. Daewoo Shipbuilding & Marine Engineering, Hyundai Heavy Industries and Samsung Heavy Industries registered a combined USD 42.1bn loans and more than USD 6bn combined losses in 2015. With falling capacity utilization and decreasing liquidity, the shipbuilders faced heightened risk of defaults. This threatened their state-owned creditors, Korea Development Bank (KDB) and Korea Export-Import Bank (KEXIM) which represented around 60% of the total credit from the banking sector. Bank of Korea (BOK) proposed a bank recapitalization fund to buy the contingent convertible bonds of KDB and KEXIM. Analysts expected that the restructuring process would only amount to the state-owned banks' recapitalization to avoid layoffs by giving more credit to shipbuilders so that the actual macroeconomic impact would be kept minimal. (CNBC)

Big oil groups raise net debt by a third to cope with low prices

May 29. The net debts of the fifteen largest Western oil companies have surged by a third over the past year. As the oil price plunged to USD 27 per barrel in the first quarter, many oil companies had to borrow to finance their investment programs and dividend payments. In light of the increased indebtedness and plummeting revenues, oil companies are likely to cut more jobs, investments, and dividends, and pursue more defensive mergers and acquisitions. Although the recent rebound in oil prices is improving the companies' cash flow, oil companies are still under financial strain with crude prices at the present levels. The rising debts and lowered expectations for future oil prices have also prompted credit downgrades among oil companies. (FT)

China loses world No. 2 creditor rank to Germany amid yuan woes

May 27. Germany edged out China as the world's second-largest supplier of external credit for the first time in at least a decade last year as the Asian nation's authorities spent big to support a weakening yuan. However, outflows have moderated this year, as the authorities stabilized the economy and the yuan. China's net foreign assets fell to USD 1.6tn at the end of last year, while Germany's rose to USD 1.62tn. Japan, the top creditor since 1991, remained the biggest with USD 2.82tn. (Bloomberg)

Macau economy seen at risk as Moody's downgrades gaming hub

May 25. Moody's downgraded the Macau's government credit rating to Aa3 from Aa2 with a negative outlook. The agency also lowered Macau's long-term foreign currency bond ceiling to Aa2 from Aaa and its long-term foreign currency deposit ceiling to Aa3 from Aa2. Moody's cited Macau's expected economic contraction and over reliance on gaming and tourism market as the reasons for the downgrade. In response to the downgrade, the city's monetary authority reiterated that Macau's economic and financial conditions remain fundamentally sound. In 2015, Macau's economy contracted by 20.3% as its casinos were hit by China's slowdown and a government anti-graft campaign. (Bloomberg)

LendingClub founder turned to Mack for emergency loan help (Bloomberg)

Hyundai Merchant Marine creditors agree to debt swap (Reuters)

Moody's downgrades Deutsche Bank to Baa2 (FT)

Regulatory Updates

India's market regulator seeks to cut number of traded companies

May 25. India's market regulator plans to delist more than 4,000 listed companies whose shares are not actively traded, as it tightens supervision of Asia's fourth-largest stock market. The clean-up includes 1,200 companies whose shares have been suspended from the trading on the BSE Ltd. the National Stock Exchange of India Ltd. for the past seven years. The 3,000 companies listed on the defunct regional bourses would also face the axe. Founders of the companies marked for delisting will be required to make exit offers to shareholders by setting a fair value to their shares, which will be determined by an independent valuer. Companies willing to resume trading on the BSE and NSE would be allowed to do so after meeting regulatory requirements. (Bloomberg)

CFTC closes US banks' loophole on swaps

May 24. Following the Commodity Futures Trading Commission's (CFTC) approval of tighter restrictions over swaps booked by overseas branches of US firms, US banks lost the ability to transfer their swaps business overseas. The regulations, that were intended to close legal loopholes pertaining to swaps, would require offshore units of US banks to adhere to CFTC rules even when the units' American parents are not explicitly caught for their involvement in the trades. According to CFTC Chairman Timothy Massad, the approved regulations would "help address the risk that can flow back into the United States from the offshore activity, even when the subsidiary is not explicitly guaranteed by the US parent". Swaps have been placed under greater scrutiny by US policy makers due to its central role in the financial crisis, during which, risky bets placed by American International Group Inc.'s offshore unit almost led to the destruction of the US insurer. (WSJ)

IFRS 9 to redefine risk recognition by banks

May 22. The introduction of International Financial Reporting Standards 9 (IFRS 9) would change the process of reporting credit impairments, specifically the manner credit losses are recognized in the balance sheet and profit and loss statement. The adoption of IFRS 9 would shift current approach of recognizing impairments based on "incurred losses" to an approach based on future expectations, known as expected losses (EL). Unlike current incurred credit loss model, banks will be required to provide for expected credit losses over the lifetime of the loan, on the date the loan is first recognized, based on the level of default expected over the next 12 months. With the adoption of the new standard, banks would have to review their capital requirements, product mix and business models. Further, a surge in provisions and a subsequent impact on profit and loss account is expected, another challenge for banks in the area of capital planning. (Gulf news)

Alibaba facing SEC investigation over accounting practices (Bloomberg)

Taiwan finance regulator signals hands-off approach, with nudges (Bloomberg)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Justin Hsiao