Foreign Bond Investments of Insurers and Foreign Exchange Hedge

In the last 5 years, most Korean insurers have been expanding their overseas investments, especially long-term foreign currency bonds. Amid the prolonged low interest rate environment after the financial crisis of 2007-2009, they are actively seeking both yield enhancement and diversification through their overseas investments.

Investing abroad confronts Korean insurers with the decision of how to deal with the foreign currency exposure implied by their foreign investments. The decision about foreign exchange hedge is crucial because exposure to foreign currencies potentially alters the return and risk profile of their overall investment portfolios. Therefore Korean insurers need to decide whether to retain or to hedge the implicit currency exposure associated with their foreign investments.

In this report, we examine the impact of hedging currency exposure from the perspectives of Korean insurers. We analyze the impact of hedging on the risk and return of long-term bond investments in Australia, Germany, Japan, United Kingdom, and United States. Our dataset covers the period from April 2006 to December 2017 and includes the financial crisis of 2007-2009. We provide results for simple hedge ratios that are popular with investors. The simple hedge ratios include no hedging, half hedging, and full hedging.

According to our empirical results, we obtain the following implications for foreign long-term bond investments of Korean insurers. First, depending on a type of currency, partial hedge provides more efficient portfolios than full hedge. Second, while hedging currency exposure can reduce the risk of overseas portfolio itself, it can reduce international diversification through an increase in correlation between overseas portfolio and domestic portfolio. Last, the empirical results are
robust to variation in the investment horizon from 1 quarter to 5 years. Further empirical studies are therefore needed to decide hedging strategy exceeding 5-year investment horizon.