

RATING ACTION COMMENTARY

Fitch Affirms Construction Guarantee's IFS at 'A'; Outlook Stable

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Fitch Ratings - Singapore - 07 May 2020: Fitch Ratings has affirmed South Korea-based Construction Guarantee's (CG) Insurer Financial Strength (IFS) Rating at 'A' (Strong). The Outlook is Stable.

KEY RATING DRIVERS

The rating action noted above is based on Fitch's current assessment of the impact of the coronavirus pandemic, including its economic impact, under a set of ratings assumptions described below. These assumptions were used by Fitch to develop pro-forma financial metrics for CG that Fitch compared to both ratings guidelines defined in its criteria, and to previously established rating sensitivities for CG.

The rating takes into consideration the company's 'Very Strong' capitalisation with a 'Moderate' business profile. Additionally, it incorporates the strong state support that CG continues to enjoy. CG, which is supervised by the Ministry of Land, Infrastructure and Transport (MOLIT), was set up to promote the development of the local construction industry by providing related guarantee and insurance coverage for the construction firms. The rating also considers CG's 'Moderate' financial performance and high business concentration in the domestic construction sector.

CG operates under a regulatory capital regime modelled on the Basel III capital framework. Its regulatory capital ratio was above 300% for the past three years (2019: 352%; 2018: 341%), well in excess of the 100% regulatory minimum, providing a deep cushion for its potentially volatile business portfolio. Net premiums written (NPW) to total capital was below 0.5x at end-2019. Its capitalisation, as measured by the Fitch Prism Model score, was well into 'Strong' in 2019. CG's pro-forma capital ratios remain within Fitch's rating sensitivities, based on our assumptions to reflect the coronavirus impact. Its pro-forma risky asset ratio also remains within the median range for its rating category.

CG's financial performance is generally stable, with its combined ratio below 85% for the past three years. Its return on equity (ROE) amounted to 3% in 2019, with a three-year average of 3%. Fitch expects the economic downturn driven by coronavirus to dampen its bottom line in the short term under our rating assumptions, with some of the pro-forma profitability measures falling into the median ratio range for the 'bbb' rating category. Nonetheless, the agency believes that fundamental operating profile will remain intact and the company's operating performance will normalise after the pandemic runs its course.

CG's business profile is 'Moderate' compared with that of all other Korean non-life insurance companies, due to its moderate operating scale with limited geographical and business diversity. Fitch therefore scores CG's business profile at 'bbb+' under its credit factor scoring guidelines. CG sources more than 90% of its business premiums from South Korea.

KEY ASSUMPTIONS

Assumptions for Coronavirus Impact (Rating Case):

Fitch used the following key assumptions, which are designed to identify areas of vulnerability, in support of the pro-forma ratings analysis discussed above:

--Decline in key stock market indices by 35% relative to 1 January 2020.

--Increase in two-year cumulative high-yield bond default rate to 16%, applied to current non-investment grade assets, as well as 12% of 'BBB' assets.

--Both upward and downward pressure on interest rates, with spreads widening (including high yield by 400 basis points) coupled with notable declines in government rates.

--Capital markets access is limited for issuers at senior debt ratings of 'BBB' and below.

--A COVID-19 infection rate of 5% and a mortality rate (as a percentage of infected) of 1%.

--Impairment of beneficiary certificates by 7.8%.

--Decline in value of investment property/mortgages by 7.8%.

--For the non-life and reinsurance sectors, a negative impact on the industry-level accident year loss ratio from COVID-19-related claims at 3.5 percentage points, partially offset by a favourable impact from the auto line averaging 1.5 percentage points.

--Further negative impact on the industry-level accident year loss ratio - with respect to the niche guarantee and credit insurance market in South Korea - at an additional 3.5 percentage points

RATING SENSITIVITIES

The ratings remain sensitive to any material change in Fitch's rating case assumptions with respect to the coronavirus pandemic. Periodic updates to our assumptions are possible given the rapid pace of changes in government actions in response to the pandemic, and the pace with which new information is available on the medical aspects of the outbreak. An indication of how ratings would be expected to be impacted under a set of stress case assumptions is included at the end of this section to help frame sensitivities to a severe downside scenario.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A material adverse change in Fitch's ratings assumptions with respect to the coronavirus impact.

- Perceived weakening of state support for CG.

- Persistent weakening in business profile in terms of business franchise and operating scale.

- Regulatory capital ratio falling consistently below 200%.

- NPW/capital increasing to above 2x.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--A material positive change in Fitch's ratings assumptions with respect to the coronavirus impact.

--A positive rating action is prefaced by Fitch's ability to reliably forecast the impact of the coronavirus pandemic on the financial profile of both the South Korean non-life insurance industry and CG.

- Sustained improvement in business profile - for instance, better operating scale as well as successful and profitable business diversification in terms of business class and geographical spread.

- ROE improving to above 7% on a prolonged basis, while maintaining its regulatory capital ratio of above 300%.

Stress Case Sensitivity Analysis

--Fitch's stress case assumes a 60% stock market decline, two-year cumulative high-yield bond default rate of 22%, high-yield bond spreads widening by 600 basis points and more prolonged declines in government rates, heightened pressure on capital markets access, a COVID-19 infection rate of 15% and mortality rate of 0.75%, and an adverse non-life industry-level loss ratio impact of 7 percentage points for COVID-19 claims and an additional 7 percentage points pertaining to its niche guarantee and credit insurance market in South Korea, partially offset by a favorable 2 points for motor. It also assumes impairment of beneficiary certificates by 16.5% and

--Decline in value of investment property/mortgages by 16.5%.

--The implied rating impact under the stress case would be a downgrade of no more than one notch.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Financial Institutions issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Construction Guarantee	Ins Fin Str	A Rating Outlook Stable	Affirmed	A Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

[Insurance Rating Criteria -- Effective March 2, 2020–Aug. 25, 2020 \(pub. 03 Mar 2020\)](#)
(including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Prism Factor-Based Capital Model, v1.7.1 ([1](#))

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Construction Guarantee

EU Endorsed

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Insurance Asia-Pacific South Korea
