How the overlay approach is the solution for KBC Group

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Amendments are effective as of adoption of IFRS 9

KBC, an European bank-insurance group
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KBC

1. KBC Group, an integrated bank-insurer

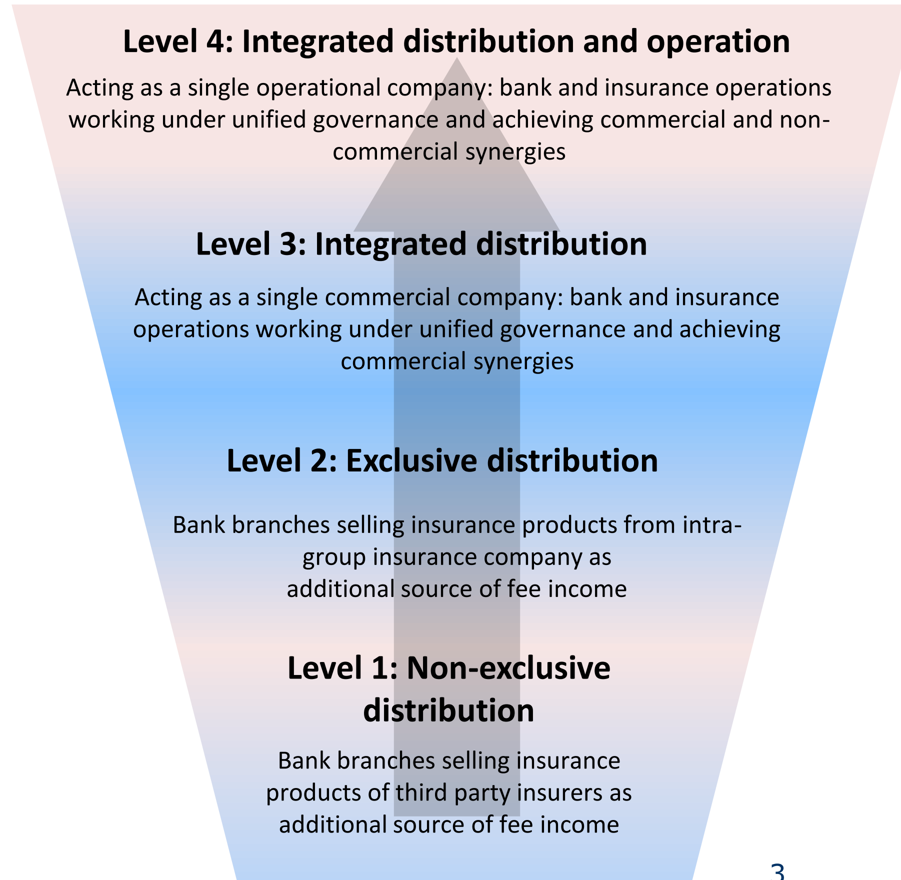
- 10 million customers with focus on serving retail, private banking, SME and mid-cap clients.

- Geographically focused on core markets of Belgium, the Czech Republic, Slovakia, Hungary and Bulgaria and also present in Ireland.

* Percentages refer to the local market share

- An integrated bank-insurance model is applied in all core markets offering a total solution package to clients , covering their banking and insurance needs.

1. KBC Group, an integrated bank-insurer



KBC's bank-insurance business model

Business model of most of the financial conglomerates

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1. KBC Group, an integrated bank-insurer

- KBC Group key figures as of 30/09/2015

Balance sheet (30/09/2015)	In million Euros
Total Assets	257.632
of which equities in the insurance entities	1.459
of which debt instruments in the insurance entities	18.793
Insurance liabilities under IFRS4	19.365
Liabilities of investment contracts	12.553

Profit & Loss (average of the last 3 years)	contribution to KBC Group result
Banking activities	between 70% and 80 %
Insurance activities	between 20% and 30%

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1. KBC Group, an integrated bank-insurer

- KBC publishes IFRS financial statements on **3 consolidation levels**

- The segment reporting at KBC Group, according to IFRS8, is **based on geographical presence** i.e. reporting of accounting figures per business unit and not on banking versus insurance activities as this is the segment reporting used by most of the financial conglomerates.

- Our product view, banking versus insurance activities, is presented in the disclosures.

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2. Impact for KBC due to the time delay between IFRS 9 and IFRS 4 phase 2

- The majority of the debt instruments of the insurer fulfill the SPPI test under IFRS 9 and can be classified amortized cost or fair value through OCI , thus not creating additional P&L volatility related to adopting IFRS 9. The volatility remains in equity (in OCI) which is comparable with the current volatility in AFS.

- IFRS 9 offers 2 options for the classification of **the equity portfolio** (Fair Value through P/L or through OCI) of the insurer, both having disadvantages as it results in a total different P&L pattern in comparison with IAS 39. Moreover, this creates a non-level playing field with entities making use of the deferral approach.

KBC is looking for a solution for the equity portfolio of the insurer when adopting IFRS 9 prior to the new insurance standard to ensure a level playing field with the deferral approach.

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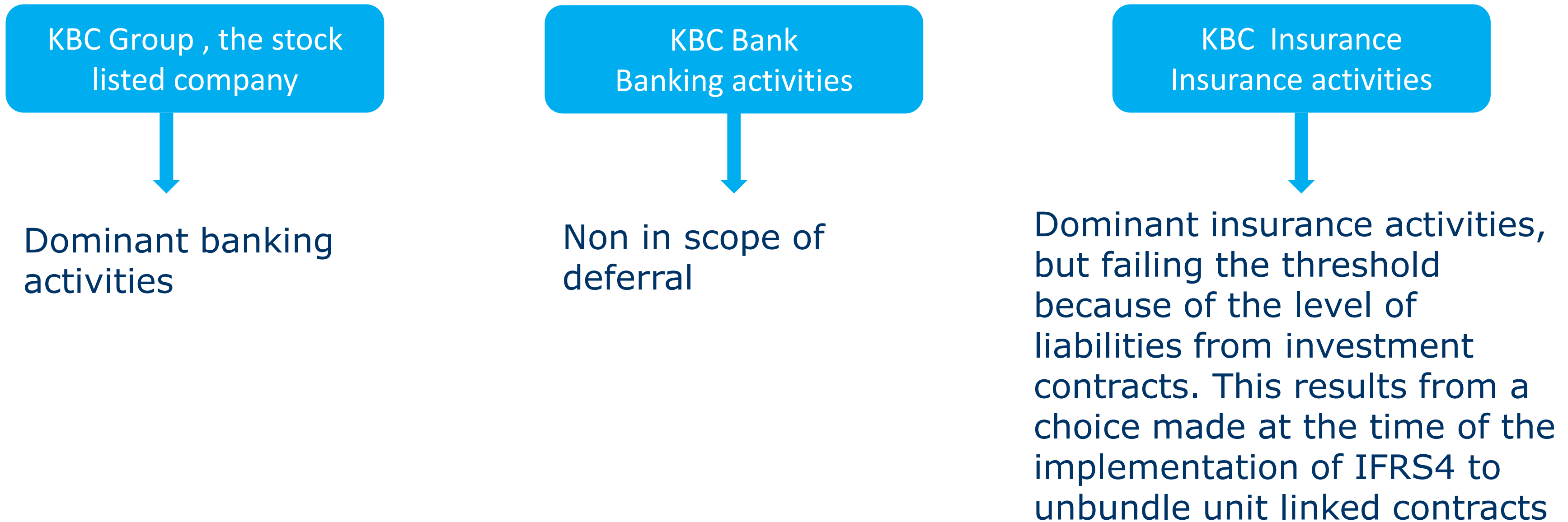
3. KBC's reporting entities are not eligible for temporary exemption of IFRS 9



The IFRS9 project within KBC Group is on track and the significant investments are made, both in people and in IT systems, to be ready for IFRS9

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3. Even if eligible for the deferral approach, we believe this is no solution for KBC

- KBC is an integrated bank-insurer but mainly benchmarked by **financial analysts** with other big European banks. Financial markets expect that KBC Group will report under IFRS9 as from 1 January 2018. Even if a deferral at the level of the holding would be possible, this is not a solution for KBC Group.

- KBC is using one **integrated accounting scheme** for banking and insurance activities. In the disclosures the product view of our insurance and banking activities is presented.

- KBC has **one operational process** preparing financial statements over the 3 consolidation levels :
  - the standalone IFRS reported figures from our bank and insurance entities are uploaded in a central consolidation tool.
  - the central consolidation tool manages the consolidation scope (which entities are in scope of which consolidation level) and steers reported figures and accounting entries to be integrated in the set of financial statements at group, bank and insurance consolidated level.

3. Even if eligible for the deferral approach, we believe this is no solution for KBC

- Our different segment reporting compared to most financial conglomerates makes applying **deferral for insurance activities operationally not feasible.**
  - We would need to change the segment reporting into banking and insurance activities. However, this view would **no longer be IFRS8 compliant** as this is not the way the activities are managed;
  - We would need to unbundle our financial statements and change our accounting schemes. This creates a significant amount of additional costs within our organisation and this for a relatively short period in time;
  - In some cases, we have **one operational back-office system**. Ex all bond portfolios are managed together, both for the bank and the insurance activities. Applying the deferral at the level of the insurance activities implies 2 different impairment models. A same type of bond may have different impairment methodologies (IAS 39 for bonds of the insurer and IFRS 9 for bonds of the bank). The same applies for our mortgages portfolio. This lack of consistency between the bank and insurance activities will confusing management and users. Segment reporting based on banking and insurance activities is not in line with how KBC manages and looks at its activities.

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3. Even if eligible for the deferral approach, we believe this is no solution for KBC

KBC is not eligible for the current deferral approach at the level of the insurance activities and an extended deferral solution would not solve the issue for KBC because :

- Financial statements are prepared in a uniform way over the 3 consolidation levels
- Changing the segment reporting into banking and insurance activities would be very costly and be confusing for management and users as a result of the lack of consistency between the banking and insurance activities, mainly re impairments.
- Financial analysts benchmark KBC Group, being an integrated bank-insurer, against other big European banks, especially in relation to IFRS 9 phase 2 Impairments.
- The costs related to deferral with segment reporting largely outweigh the cost related to applying IFRS 9 with the overlay approach.

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4. The overlay approach for the equity portfolio of the insurer ensures a level playing field

- The non-trading equity portfolio fulfills the conditions as published in the exposure draft and is therefore **a qualifying financial insurance asset for the overlay approach**
  - Covering insurance liabilities of contracts in scope of IFRS 4 (about 80% is allocated to the life business, 15% to the non-life business)
  - Classified Available For Sale (AFS) under IAS 39 and Fair Value P&L under IFRS 9.
- The additional P&L volatility related to applying IFRS 9 is removed from P&L to OCI.
- Upon de-recognition (sales of equities) the OCI reserve is reclassified from OCI to P&L and implies reporting the same results in P&L as under IAS 39

We fully understand the reason of the IASB Board for the equity treatment under IFRS 9. However, applying IFRS 9 at different moments in time creates a non-level playing field.

The overlay approach mitigates the competitive disadvantage compared to financial institutions that could make use of the deferral approach.

4. Manageable costs related to applying the overlay approach

- Continue to run the current IAS 39 systems until the effective date of the new insurance standard to measure the equity portfolio under IAS 39.
- Most equities are quoted i.e. fair values are available as these equities are currently classified AFS under IAS 39. The current IAS 39 impairment model is applicable for the equity portfolio under the overlay approach.
- Calculate the overlay adjustment amount = difference in P&L between the fair value P&L measurement under IFRS 9 and the AFS measurement under IAS 39. We only need to made additional accounting entry: recognition of the overlay adjustment amount in OCI. This only requires minimal changes in our accounting ledger and financial statements.
- Disclosures : transparent presentation of the 'IFRS 9 increased volatility adjustment' in the Income Statement.

No additional information requirements, only accounting entries and transparent disclosures. Benefits largely outweigh the costs related to applying the overlay approach for the equity portfolio.

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5. Conclusion

The current proposed overlay approach in the IASB Exposure Draft provides a suitable solution for KBC with minimal implementation costs.

We support applying IFRS 9 for the entire group. IFRS 9 in combination with the overlay approach for the insurer's equity portfolio **mitigates the competitive disadvantage** with the deferral approach, but allows internal consistency between banking and insurances. We understand that some other Belgian bank-insurance groups have the intention to apply the overlay approach.

KBC supports all temporary solutions to mitigate the inconveniences related to the time delay between IFRS 9 and IFRS 4 as financial institutions are operating under different circumstances.

To ensure a maximum level playing field both approaches should remain available and maintained in the final amended IFRS 4 phase 1 standard.

Thank you