The Overlay approach
Presentation by CNP Assurances and Munich Re

Background

The IASB's "Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts" Exposure Draft ("ED") conveys the impression that the implementation of the Overlay approach would not be challenging for entities. The following document discusses why the Overlay approach is not an appropriate alternative in practice to the Deferral approach for all insurers.

Description of the "Overlay approach"

The Overlay approach mitigates some of the effects from the volatility caused by the misalignment of the implementation of IFRS 9 and IFRS 4 Phase II by theoretically offsetting the changes in fair value of assets accounted for at FV-PL that were or would have been previously accounted for at FV-OCI or Available for Sale ("AFS") under IAS 39 ("incremental P&L impact under IFRS 9"). This option is only offered to assets backing insurance contracts under IFRS 4. The approach provides for an offsetting posting to temporarily move the incremental P&L impact from IFRS 9 into OCI[1].

Other general observations on the "Overlay approach" include:

1. It could be misleading to the users who will have to deal with two sets of financial results (one under IFRS 9 and one under a combination of IFRS 9 and IAS39);

2. It would impede consistency among players within the industry and prevent users from comparing all industry players;

3. The Overlay approach is only partly efficient as it does not deal with the entire volatility generated by IFRS 9. Indeed, for assets previously held at cost under IAS 39, the volatility created by IFRS 9 is merely moved from P&L to OCI. The overall impact to an entity depends on the initial share of financial assets accounted for at amortized cost under IAS 39;

4. The Overlay approach requires to completely implement the two asset-accounting standard. Notably, our understanding is that it requires to maintain previous IAS 39 impairment tests (for both SPPI bonds, non SPPI bonds and equities);

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[1] The Overlay approach also has strong conceptual limits:

a) the additional volatility in OCI for assets previously carried at amortized cost is not, to our understanding, neutralized (Overlay moves the volatility created by the misalignment of IFRS 9 and IFRS 4 Phase II from P&L to equity but volatility still remains); and
b) IFRS 9 with the Overlay approach and IAS 39 accounting for equities approaches are identical if the valuation changes are equivalent to the amount what was would have been necessary to impair (and recycle) according to IAS 39, if valuation decreases.

5. The system efforts include:
    a. The Overlay approach IAS 39 and IFRS 9 would have to run in parallel and therefore the chart of account, corresponding sub-assignments and attributes as well as the footnotes for both sets of requirements would have to be available. Next to the consequent costs the consequent complexity might hardly be viable;

    b. IAS 39 and IFRS 9 asks for different valuation for the assets under discussion. That means entities would need sub-ledgers that have the ability of posting those different valuations. Very often, this is lacking;

    c. Running two parallel systems would prevent entities from implementing the target system architecture – because short-term interim solutions have to be set up - with the above mentioned consequences (see below for more information on IT systems impact);

    d. That also means that more staff (and therefore additional costs) is necessary to run these processes;

    e. Additional control processes have to be implemented to ensure consistency of the data;

6. Besides the technical costs, this will confuse management and users;
    a. The field test studies have shown that the volume of assets accounted for at FV-PL is such that the reporting processes will have to be automated, and that those assets have to be recorded in the back office system. Roughly several thousand lines of assets are within the scope of the overlay which represents a significant part of the insurance portfolio;

    b. It will be costly to have both accounting standards implemented in the financial investments' back office because of the required parallel run. So far, estimates of the cost (in addition to the full IFRS 9 implementation cost) of applying the Overlay approach range from a 40% to 100% increase in the costs linked to the financial-assets' reporting. Costs definitively exceed benefits;

7. It does not prevent from subsequently reassessing assets in 2021 (once the future insurance standard is implemented) imposing, in fact, two implementations of IFRS 9. This has some strong consequences for both management and users of the accounts;

8. The Overlay approach will impose to manage the investment strategy of the insurance activities simultaneously under two different accounting standards, with direct consequences on the management accounts, on the performance ratios monitored and on the reporting processes. One could question the limits it could impose of the management's stewardship of IFRSs; and

9. For conglomerates, being forced to implement IFRS 9 if the insurer would have been eligible at a reporting subgroup level, may cause a reconsideration of the insurer's investment strategy at a time when all insurers are invited to invest in long-term assets and to support small-and-medium companies, not to mention the resulting non-level playing field it will introduce into the market.

Impact on the management of securities and IT systems

The full implementation of IFRS 9 requires the following structural devices:

- Implementation of a decision tree for classification of the assets;
- Development of ECL systems and processes including technology with the accompanying need to collect and store all relevant assumptions (PD, LGD, EAD…) in the upstream IT system (back-office if not front office);
- Review of the accounting schemes and adaptation of all downstream tools.

The restatement posting that would be recognized over the period of convergence with the future insurance standard also requires maintaining a securities management IT that is able to identify securities which accounting has changed (e.g. from FV-OCI/AFS to FV-PL). The management system under IAS 39 should therefore be maintained at least to track and identify:

- Acquisitions, sales and redemptions;
- Restructuring operations;
- Changes in fair value;
- Impairment movements which would have been recognized under IAS 39.

It is therefore necessary to manage and account for financial assets (listed securities and unlisted) under both standards and to maintain within the upstream IT system two sets of accounts.

The information stored in the financial-asset IT systems would then be sent and centralized into the downstream accounting system, which is only capable of recording the effects of shadow accounting and deferred tax. The need for this information to be send at the most granular level into the accounting IT system derives from the following constraints:

- Shadow accounting has to be implemented according to the granularity of the contractual, legal or managed portfolios which assets back "insurance" liabilities;
- Deferred tax has to be considered according to each particularity, nature or holding strategy of the assets under local tax specificities (participations, venture capital funds, real estate companies, open-end funds...).

Two Potential Options for Implementation:

Two options have been considered:

a) **1st option**: the financial assets information is sent in 2 different frameworks and then compared - The Overlay posting could thus be calculated as the difference between the two descending information. The disadvantage of this option stems from the dual treatment, leading to double the processing time (not to mention the human resources requirements);

b) **2nd option**: the Overlay postings are generated by the financial assets IT system and then posted in the accounting IT system - In this case, the setting of the upstream tools must be reviewed and adapted to manage the movements on the securities involved in the "Overlay approach" and trigger scripts automatically in the IFRS 9 accounting framework. The feasibility of implementing such developments in financial assets IT systems is not guaranteed and significant and heavy developments of the systems should be asked to the developers and companies editing these software programs.

The subsequent additional constraints of:

a. maintaining the existing IAS 39 framework,
b. integrating new additional back-office information into an accounting tool, and
c. accounting for shadow accounting and deferred taxes amount leads to dually and simultaneously maintaining and developing two standards (as it is already performed with IAS 39 and local GAAPs (eg. French GAAP)). The recurring expense generated by the Overlay approach during the transition period will add an estimated minimum 40% to costs in addition to the cost of implementing IFRS 9.

<u>Difficulties identified</u>

At least one insurer estimates that nearly 5,000 active lines potentially affected by the "Overlay approach" which is thus not compatible with a "single top accounting entry" at the level of the group entity level. This entry cannot properly assess and embrace all the complexities stemming from the different nature of cash-flows and arbitrages within all the portfolios; it is only conceivable for an individual asset.

Its implementation requires the maintenance of two standards and raises the following difficulties:

- Traceability and auditability of the correction by the Overlay: a "single top accounting entry" needs to be justified and therefore documented at the lowest granular level;
- Management events to be accounted for in two frameworks in the upstream accounting IT systems (at least back-office), which will generate additional heaviness in the systems;
- Additional accounting schemes to be implemented, including the recycling of OCI reserves accumulated during the Overlay approach in case of disposal of the asset (or de-designation);
- Needed availability of the information according to the same agenda/deadline of the closing of the accounts with the same quality of data;
- Dual designation of the assets and review in 2018 and then again when IFRS 4 Phase II is implemented (eg. in 2021).