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**Ref: IASB's Exposure Draft *Prepayment Features with Negative Compensation*
– Proposed amendments to IFRS 9**

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process regarding the Exposure Draft (ED) *Prepayment Features with Negative Compensation*. We are pleased to provide you with the following comments with the aim of improving the transparency and enforceability of financial statements.

Like EFRAG, ESMA is generally supportive of the IASB's responsiveness to practical issues, which may risk the consistent application of IFRS and reduce the degree of investor protection in the European Union. However, while ESMA does not disagree with the IASB pursuing further these amendments, it has serious concerns about their purpose and timing. Consequently, we would suggest that the IASB better articulates why it decided to propose these amendments at this particular point in time, as the mandatory application of IFRS 9 is just a few months away. Additionally, we think the IASB should better explain why the proposed scope for the exception is appropriate.

Once these aspects are clarified, unlike EFRAG, ESMA concurs with the IASB's objective to narrowly restrict the scope of the proposed exception and therefore we also strongly support the proposed eligibility conditions. ESMA further suggests accompanying these conditions with the scope exclusion that is currently only mentioned in the Basis for Conclusions of the ED for those prepayment options whose negative compensation depend on the instrument's current fair value.



Our detailed comments on the ED are set out in Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

A handwritten signature in blue ink, consisting of a stylized 'S' followed by a vertical line and a horizontal stroke.

Steven Maijor

Appendix I – ESMA’s detailed answers to the questions in the ED

Question 1 Addressing the concerns raised

Paragraphs BC3–BC6 describe the concerns raised about the classification of financial assets with particular prepayment features applying IFRS 9. The proposals in this Exposure Draft are designed to address these concerns.

Do you agree that the Board should seek to address these concerns? Why or why not?

1. ESMA does not disagree with these amendments if they effectively address a widespread implementation or application issue relating to a well-defined, targeted and circumscribed population of instruments for which the existence of prepayment features with negative compensation could be consistent with the SPPI test.
2. While ESMA is generally supportive of the IASB’s prompt intervention to address issues that arise in practice, it has some major concerns with the underlying reasoning, timing and scope of the proposed amendments, as described in the following paragraphs. Some of these concerns are similar to those expressed in the Alternative View of the ED.
3. Firstly, the IASB has not made clear in detail what type of instruments these amendments address and whether they are widespread. ESMA notes that the amendments may result in economically similar instruments (i.e. prepayment options to prepay at current fair value and prepayment options to prepay at an amount based only on some of the components of the instrument’s fair value) being accounted for differently. As most European enforcers have not identified the negative prepayment features as being common in their respective jurisdictions, ESMA is not able to assess whether this issue is so relevant in practice to justify an amendment to IFRS 9 so close to its adoption date and a different accounting for economically similar instruments.
4. Secondly, introducing an additional exception in IFRS 9 defies one of the main objectives of the new standard that is to reduce complexity in financial instruments accounting. Furthermore, this proposed exception may have behavioural consequences as it may create a precedent for further requests to amend IFRS 9 when its principle-based approach does not fit with the desired accounting outcome of certain instruments.
5. Thirdly, it is not clear from the ED whether particular innovations have occurred in the field of prepayment features with negative compensation since the finalisation of IFRS 9 to justify amending IFRS 9 just a few months before its mandatory application. ESMA also notes that the requirements in IFRS 9 relating to prepayment options have not changed since the original publication of the first phase of the standard in 2009.
6. Therefore, before proceeding with the amendments, ESMA would encourage the IASB: to address the above concerns by better articulating in the Basis for Conclusions: (i) why it decided to propose these amendments at this juncture immediately before IFRS 9 is mandatorily applicable; (ii) why the scope of the amendment is deemed to be appropriate;

and (iii) whether and why the amendments may result in different accounting treatment for instruments which may be economically similar. These clarifications will also help the IASB managing any future expectations regarding the possibility to make exceptions to the cornerstones of IFRS 9.

7. Finally, in order to ensure the consistent application of IFRS 9, if the IASB decides not to pursue these amendments, ESMA believes that it is important that an agenda decision of the IFRS IC officially clarifies the treatment of prepayments options with negative compensation.

Question 2— The proposed exception

The Exposure Draft proposes a narrow exception to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of a prepayment feature. Specifically, the Exposure Draft proposes that such a financial asset would be eligible to be measured at amortised cost or at fair value through other comprehensive income, subject to the assessment of the business model in which it is held, if the following two conditions are met:

- (a) the prepayment amount is inconsistent with paragraph B4.1.11(b) of IFRS 9 only because the party that chooses to terminate the contract early (or otherwise causes the early termination to occur) may receive reasonable additional compensation for doing so; and*
- (b) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.*

Do you agree with these conditions? Why or why not? If not, what conditions would you propose instead, and why?

8. ESMA agrees with the proposed conditions, as they are consistent with the overall objective of addressing a narrowly defined population of instruments.
9. ESMA acknowledges that these conditions are more restrictive than those that are applicable to prepayment options already included in the scope of IFRS 9 and that they may result in the amendments being applicable only to a very narrow population of instruments.
10. However, ESMA notes that especially the condition that the *fair value of the prepayment feature is insignificant at initial recognition of the financial asset*, is needed as a safeguard in response to the increased potential variability of cash flows that is associated with the existence of such negative prepayment options which introduce a sort of economic leverage in the *host* instrument. This condition is also consistent with paragraph B4.1.18 of IFRS 9 as it *de facto* specifies when a certain cash flow characteristic – i.e. the negative

prepayment feature – has an effect on the contractual cash flows of the entire instrument that is not regarded as *de minimis*.

11. Furthermore, restricting the amendment to a very narrow population of instruments is consistent with the fact that the original exception for prepayment features in IFRS 9, which was already limited in scope, is being enlarged to include also options that potentially give rise to negative compensation. In this respect, ESMA believes that it is important that this amendment is not an opportunity to generically broaden the SPPI test to instruments with contractual cash flows that are inconsistent with a basic lending arrangement.
12. ESMA is also concerned that important aspects of the guidance relating to the proposed amendments are conveyed in the Basis for Conclusions. Specifically, BC18 excludes from the scope of the exception those features whereas the amount at which a financial asset can be prepaid is its current fair value and gives rise to negative compensation.
13. ESMA supports this scope exclusion, but believes that it should be part of the authoritative guidance in IFRS 9 because it introduces a specific limitation in the *parameter* that is used to calculate the amount of the prepayment.
14. This limitation is not included in IFRS 9 and covers a different scope than the general condition relating to ‘reasonable compensation’, therefore in ESMA’s view, it should be part of the body of the standard or the Application Guidance. However, ESMA suggests the IASB to verify whether incorporating any of the guidance contained in the Basis for Conclusions could have unintended consequences for other non-negative prepayment features.
15. Finally, ESMA notes that the example used in BC15 may be inaccurate. Indeed, Asset B does not introduce any contractual cash flow amounts that differ from Asset A, but the two instruments have prepayment options that are triggered at different market conditions and therefore their cash flow profile may not be identical. ESMA would therefore suggest the IASB to consider these circumstances and, if appropriate, amend BC15 accordingly.

Question 3— Effective date

For the reasons set out in paragraphs BC25–BC26, the Exposure Draft proposes that the effective date of the exception would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018 with early application permitted.

Do you agree with this proposal? Why or why not? If you do not agree with the proposed effective date, what date would you propose instead and why? In particular, do you think a later effective date is more appropriate (with early application permitted) and, if so, why?

16. ESMA agrees with the proposed effective date.

Question 4— Transition

For the reasons set out in paragraphs BC27–BC28, the Exposure Draft proposes that the exception would be applied retrospectively, subject to a specific transition provision if doing so is impracticable.

(a) Do you agree with this proposal? Why or why not? If not, what would you propose instead and why?

As described in paragraphs BC30–BC31, the Exposure Draft does not propose any specific transition provisions for entities that apply IFRS 9 before they apply the exception.

(b) Do you think there are additional transition considerations that need to be specifically addressed for entities that apply IFRS 9 before they apply the amendments set out in the Exposure Draft? If so, what are those considerations?

17. ESMA agrees that the exception shall be applied retrospectively subject to a specific transition provision if doing so is impracticable.