EFRAG
European Financial Reporting Advisory Group

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Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9) Draft Comment Letter

Comments should be submitted by 17 May 2017 by using the 'Express your views' page on EFRAG website or by clicking here

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

[Date]

Dear Mr Chairman,

Re: IASB ED/2017/3 *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9)

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the exposure draft, ED/2017/3 *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9)*, issued by the IASB on 21 April 2017 (the 'Amendments').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG considers that financial instruments containing symmetric prepayment options could be eligible for measurement at amortised cost or at fair value through other comprehensive income ('FVOCI') subject to the conditions proposed in the Amendments. EFRAG assesses the negative sign of the reasonable compensation for early termination should not be the sole reason for preventing measurement of a financial contract at amortised cost or FVOCI.

EFRAG agrees that the Amendments should have a narrow scope and hence agrees with the proposed eligibility criteria. However, EFRAG sees benefit in asking its constituents whether these eligibility criteria affect the right instruments and do not create spill-over effects to the application of the SPPI-test.

EFRAG is of the view that modifying IFRS 9 *Financial Instruments* a few months before its implementation may negatively affect the significant implementation efforts already taken by many preparers and early adopters, as well as the preparations taken by users.

For these reasons, EFRAG assesses that the IASB should do its utmost to speed up the finalisation of the Amendments. In EFRAG's view, the final amendments to IFRS 9 should not be accompanied by references that interpret existing IFRS 9 on the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of asymmetric prepayment options, which is beyond the scope of the proposed Amendments.

Further, EFRAG recommends that the IASB include an effective date of 1 January 2019, rather than the date proposed in the Amendments, with earlier application permitted.

If the proposed Amendments can be applied at the same time as IFRS 9, EFRAG agrees with applying them retrospectively. However, even if the IASB expects to finalise the Amendments to IFRS 9 before 1 January 2018, EFRAG requests the IASB to provide transition provisions for addressing the situation of jurisdictions where the final amendments will be applied later than the effective date of IFRS 9 because of the need to apply an endorsement process and/or translate the standard.

EFRAG's detailed comments and responses to the questions in the Amendments are set out in the Appendix.

If you would like to discuss our comments, please do not hesitate to contact Didier Andries, Joachim Jacobs, Ioanna Chatzieffraimidou or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions in the Amendments

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 these Amendments are designed to address these concerns.

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

Notes to constituents

1 *After IFRS 9 Financial Instruments was issued, the IFRS Interpretations Committee (the Interpretations Committee) received a submission questioning how to classify particular prepayable financial assets when applying IFRS 9. Specifically, the Interpretations Committee was asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding ('SPPI') if its contractual terms permit the borrower to prepay the instrument at a variable amount that could be more or less than unpaid amounts of principal and interest, such as the instrument's current fair value or an amount that reflects the instrument's remaining contractual cash flows discounted at the current market interest rate.*

2 *The prepayment options described in the submission to the Interpretations Committee could force the lender to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. That is, in effect, the prepayment includes an amount that reflects a payment to the borrower (i.e. negative compensation), instead of compensation from the borrower, even though the borrower chose to terminate the contract early.*

3 *Interpretations Committee members suggested that the IASB consider whether amortised cost measurement could provide useful information about particular financial assets with prepayment features that may result in 'negative compensation', and if so, whether the requirements in IFRS 9 should be changed in this respect. However, the Interpretations Committee acknowledged that amortised cost measurement would not be appropriate for all such prepayable financial assets and it could be difficult to define the relevant population. As a result of the Interpretations Committee's request, the IASB is proposing a narrow scope exception to IFRS 9.*

EFRAG's response

EFRAG welcomes the IASB addressing the concerns related to prepayment features with negative compensation as it will clarify the accounting for these financial instruments.

4 EFRAG appreciates the IASB's initiative to address concerns raised during the implementation of IFRS 9 as, based on initial outreach, symmetric prepayment options exist in different types of loans in various jurisdictions across Europe. Our initial outreach also revealed that symmetric prepayment options do not necessarily arise from a legal or regulatory requirement. Further, symmetric prepayment options are generally not contingent on the occurrence of any specific 'trigger' event; although in some contracts they could only be exercised at certain dates.

5 EFRAG acknowledges the timing is short because the IASB project plan leaves little room for finalising the amendments to IFRS 9 much before the effective date of

IFRS 9, which creates difficulties for jurisdictions with translation requirements and/or endorsement processes, such as the European Union ('EU'). However, EFRAG is of the view that addressing the concerns related to prepayment features with negative compensation is worthwhile as it will clarify the accounting for these financial instruments.

6 Consequently, EFRAG urges the IASB to do its utmost to finalise the proposals in the shortest timeframe possible.

Question 2 – The proposed exception

The Amendments propose 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 Amendments propose 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:

- 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
- 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?

Notes to constituents

7 The exception to IFRS 9 the IASB is proposing applies to particular prepayable financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 but do not meet that condition only as a result of the prepayment feature. Such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are 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) *the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset.*

8 With regard to the first condition, the IASB recalls that amortised cost provides useful information about particular financial assets with simple cash flows that represent principal and interest. Amortised cost is calculated using the effective interest method, which is a relatively simple measurement technique that allocates interest over the relevant time periods using the effective interest rate. More complex cash flows require a valuation overlay to contractual cash flows (i.e. fair value) to ensure that the reported financial information is useful to users of financial statements.

9 The existing notion of reasonable additional compensation for early termination of a contract in IFRS 9 accommodates a prepayment amount that can be more or less than unpaid amounts of principal and interest, depending on which party chooses *to terminate the contract early. Prepayment features that do not depend on which party chooses to prepay, but only on the movement in the relevant market interest rate, may result in negative compensation (i.e. a penalty) and are inconsistent with cash flows addressed in paragraph B4.1.11(b) of IFRS 9.*

10 It follows that financial assets that are prepayable at their fair value (so called 'make whole prepayments') are inconsistent with measurement at amortised cost as such prepayment amounts may not only result in negative compensation but also because the amount exposes the holder to changes in the fair value of the instrument and contractual cash flows resulting from such exposure are not solely payments of principal and interest.

11 The second eligibility condition is proposed to ensure that the scope of the proposed exception is sufficiently narrow and that amortised cost measurement is not extended beyond the population of financial assets for which the effective interest method could provide useful information. To achieve that objective, the fair value of the prepayment feature should be insignificant when the entity initially recognises the financial asset. IFRS 9 does provide the possibility to account for a catch-up adjustment if an entity revises its estimates of contractual cash flows. However, a prepayment feature that can be called upon by both borrower and lender raises the frequency in which cash flows can arise that are different to the cash flows accommodated by paragraph B4.1.11 (b) of IFRS 9. The potential occurrence of more frequent catch-up adjustments is not considered to be in line with a simple measurement technique that allocates interest using the effective interest rate over the relevant time period.

EFRAG's response

EFRAG supports the proposal that financial instruments containing symmetric prepayment options could be eligible for measurement at amortised cost or at FVOCI and agrees with the conditions proposed by the Amendments. EFRAG assesses the negative sign of the reasonable compensation for early termination should not prevent measurement of a financial contract at amortised cost or FVOCI. EFRAG assesses that the proposals should not be accompanied by references that interpret existing guidance in IFRS 9 on the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of asymmetric prepayment options, which is beyond the scope of the proposals in the Amendments.

12 Amortised cost is a relatively simple measurement technique and is only applied to financial assets with contractual cash flows that are solely payments of principal and interest and should be consistent with a basic lending arrangement.

13 EFRAG has considered the SPPI test and has concluded that its application will generally lead to relevant information (i.e. amortised cost or fair value in the statement of financial position depending on the applicable business model). The SPPI test excludes instruments with contractual features giving rise to exposure to risks or fluctuations unrelated to a basic lending arrangement, such as leverage or changes in equity prices or commodity prices.

Assessing the first eligibility criterion

14 EFRAG understands that the proposed Amendments address those symmetric prepayment options that would meet the requirements in paragraph B4.1.11(b) of IFRS 9, except for the fact that they could result in reasonable compensation for the early termination of the contract that is negative. Thus, the contract would fail the SPPI test in existing IFRS 9 because of the possibility that the lender may be required to pay (instead of receive) compensation.

15 EFRAG assesses the main issue to be which measurement basis would provide the most useful information to users of financial statements. EFRAG agrees that a measurement at amortised cost can provide relevant information for financial instruments that contain prepayment features with negative compensation, if that negative compensation for early termination of the contract does not significantly affect the effective interest rate calculation at inception.

16 EFRAG notes the reference of the IASB in paragraph BC18 of the Basis for Conclusions of the proposed amendments that financial assets that are prepayable at fair value do not qualify for an amortised cost measurement, because such a prepayment amount is inconsistent with paragraph B.4.1.11(b) of IFRS 9. That is, because the amount exposes the holder to changes in the fair value of the instrument, and contractual cash flows resulting from such exposure are not solely payments of principal and interest. In other words, the IASB concluded that a fair value amount is not a reasonable compensation for the early termination of the contract.

17 Moreover, in paragraph BC18 of the proposed Amendments, the IASB concludes that a financial asset that is prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument *if* that prepayment amount is inconsistent with paragraph B.4.1.11(b), because the amount exposes the holder to factors that could result in contractual cash flows that are not solely payments of principal and interest. EFRAG understands from this that when the cost to terminate the hedge is a proxy for principal and interest, or when the hedge is fully collateralised, the inclusion of such a condition in the contract would not prevent the financial asset from passing the SPPI test whereas the financial asset would fail the SPPI in other cases.

18 EFRAG is concerned that these references in the Basis for Conclusions go beyond the scope of the proposed Amendments to IFRS 9, as they seem to interpret existing guidance in IFRS 9 on the meaning of 'reasonable compensation'. EFRAG understands that the initial question raised to the IFRS Interpretations Committee was whether particular financial assets could be measured at amortised cost; that is, 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 symmetric prepayment feature.

Assessing the second eligibility criterion

19 EFRAG agrees that the fair value of the prepayment feature should be insignificant at initial recognition, as it best reflects the solely payment of principle and interest nature of the financial asset.

Overall assessment

20 EFRAG agrees with both eligibility criteria as proposed by the IASB for the reasons outlined in the previous paragraphs. EFRAG expects that preparers have already analysed which of their financial instruments pass the SPPI test as the implementation date of IFRS 9 is very close. EFRAG assesses that the proposals in the Amendments should not be accompanied by references that could interpret existing guidance in IFRS 9 on the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of other instruments, including those with asymmetric prepayment options, which is beyond the scope of the Amendments.

21 EFRAG is cautious about potential spill-over effects of the Amendments, i.e. whether the eligibility criteria of the Amendments could affect other financial instruments than the ones intended. If this were the case, EFRAG asks its constituents to provide evidence of this in responding to the Draft Comment Letter.

Question to Constituents

22 In applying the eligibility criteria, do you have evidence of financial assets with prepayment features that would not pass the SPPI test, when these financial assets would pass the SPPI test if the potential negative compensation is ignored? Please explain.

Question 3 – Effective date

For the reasons set out in paragraphs BC25-BC26, the Amendments propose 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?

Notes to constituents

23 The IASB is proposing that an entity shall apply the Amendments for annual periods beginning on or after 1 January 2018 with earlier application permitted. If an entity applies those Amendments for an earlier period, it shall disclose that fact.

24 The IASB thinks there would be significant benefits if entities initially apply IFRS 9 taking into account the effect of the proposed exception. Specifically, the IASB thinks that it would be inefficient and burdensome for entities to initially apply IFRS 9 without this exception and then be required to change the classification and measurement of some prepayable financial assets when they apply the exception at a later date.

25 However, the IASB acknowledges that the proposed effective date may not provide sufficient time for entities to determine the effect of the Amendments and for translation and endorsement activities for some jurisdictions. Therefore, the IASB is asking for feedback on whether a later effective date, with early application permitted, would be more appropriate.

EFRAG's response

EFRAG supports a later effective date of 1 January 2019, with earlier application permitted. This will enable those jurisdictions with translation and/or endorsement processes to adopt the proposed Amendments before the mandatory effective date.

26 EFRAG is concerned about the short time period between the expected date of issuing the proposed Amendments and the proposed effective date of 1 January 2018. EFRAG considers that this will create difficulties for all jurisdictions with a translation or endorsement process, including the EU, and it is highly unlikely that such processes can be finalised by 1 January 2018 in all jurisdictions.

27 Therefore, EFRAG strongly recommends that the IASB provide a later effective date of 1 January 2019, with early application permitted. However, even if this is the case, entities in the EU that apply the Amendments at the due date would have to classify and measure financial assets containing such prepayment options at fair value through profit or loss when they first apply IFRS 9. Then, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, they will have to change the classification and measurement of those financial assets to amortised

cost or FVOCI for those financial assets to which the final amendments apply. That is, they would be in the same position as entities that have already adopted IFRS 9. We address this in our comments on question 4 below.

Question 4 - Transition

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

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

As described in paragraphs BC30-31, the Amendments does not propose any specific transition provisions for entities that apply IFRS 9 before they apply the exception.

- 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 ED? If so, what are those considerations?

Notes to constituents

28 *The IASB is proposing that, consistent with the existing requirements in IFRS 9, the Amendments would be applied retrospectively. Accordingly, an entity would need to determine whether a prepayable financial asset meets the conditions set out in paragraph B4.1.12A, on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, including whether the fair value of the prepayment feature was insignificant.*

29 *The IASB believes that entities will have the required fair value information because the information is required to apply the embedded derivative requirements in IAS 39. However, the IASB is acknowledging that it may be impracticable for an entity to determine whether the fair value of the prepayment feature was insignificant at the date of initial recognition if it had previously designated the financial asset under the fair value option applying IAS 39. Accordingly, the IASB proposes that if it is impracticable for an entity to make that determination on the basis of the facts and circumstances that existed at the initial recognition of the asset, then the entity must assess the contractual cash flow characteristics of the financial asset without taking into account the proposed exception set out in the Amendments. This proposal is similar to the existing transition provisions in IFRS 9 for assessing some other contractual features (see paragraphs 7.2.4 and 7.2.5 of IFRS 9).*

30 *The IASB is proposing that an additional disclosure requirement is added to IFRS 7 Financial Instruments: Disclosures for circumstances in which an entity applies the transition provision described above (and thus assesses the contractual cash flows without taking into account the proposed exception). In such circumstances, the entity would disclose the carrying amount of those financial assets until they are derecognised.*

31 *As noted above, the effective date of the proposed Amendments is the same as the effective date of IFRS 9 therefore the IASB believes that most entities would initially apply IFRS 9 taking into account the effect of the proposed exception. However, the IASB acknowledges that some entities have already early applied IFRS 9 and would therefore need to apply the exception retrospectively, subject to the requirements for changes in accounting policies in IAS 8. Therefore the transition provisions in IFRS 9 would not be applicable when the entity applies the Amendments.*

EFRAG's response

EFRAG agrees that the Amendments should be applied using the transition provisions provided in IFRS 9 if applied at the same time as IFRS 9.

However, EFRAG considers that the final amendments should include additional guidance for entities that apply IFRS 9 before they apply the Amendments.

32 Regarding the proposed transition provision, EFRAG generally supports retrospective application of new, or amendments to existing, Standards and Interpretations. Therefore, assuming that the final Amendments are applied at the same time as IFRS 9, EFRAG agrees that they should be applied retrospectively. EFRAG also considers that the normal transition requirements of IFRS 9 will cater for entities applying the final Amendments at the same time as first applying IFRS 9.

33 However, the situation is different if an entity has already applied IFRS 9 before applying the Amendments. EFRAG notes that, with retrospective application, obtaining the fair value of an instrument in prior years might be a challenge.

34 EFRAG recommends that the IASB provide some transition provisions that address this issue. Such guidance could permit the fair value disclosed in the most recent financial statements to be deemed cost for the purposes of measuring amortised cost.