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Prepayment features with negative compensation – Proposed amendments to IFRS 9 - Draft Comment Letter

Objective

1 The objective of this paper is to discuss the EFRAG Secretariat's responses to the questions expected to be raised in the forthcoming Exposure Draft *Prepayment Features with Negative Compensation*[1] (Proposed amendments to IFRS 9 *Financial Instruments*) ('the Amendments'). The EFRAG Secretariat would like to obtain EFRAG TEG members' initial views on whether they agree with the direction of the draft comment letter.

2 The EFRAG Secretariat drafted its responses based on the information that is publicly available and based on the EFRAG Secretariat's understanding of the expected content of the forthcoming Exposure Draft.

Question 1

Do you think that the IASB should address the concerns about classification of financial assets with particular prepayment features? Why or why not?

EFRAG's response

EFRAG supports the Amendments as they address uncertainty in the measurement of the financial instruments that contain symmetric prepayment options. These financial instruments are issued in a number of European jurisdictions. EFRAG considers that lifting this uncertainty will enhance the significant efforts already taken by preparers in implementing IFRS 9.

3 EFRAG appreciates the IASB's initiative to address concerns raised during the implementation of IFRS 9 *Financial Instruments* as, based on initial outreach, symmetric prepayment options exist in various types of loans in various jurisdictions across Europe. The initial outreach also revealed that symmetric prepayment options do not generally arise from a legal or regulatory requirement, but rather are common market practice. 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.

4 Overall, EFRAG concludes that symmetric prepayment options are common features in many different lending transactions. Consequently, not addressing the

[1] The title of the project is based on the latest IASB work plan. It was previously called Symmetric Prepayment Options.

concerns raised would prolong the uncertainty about the measurement of the financial instruments involved.

5 EFRAG notes the timing chosen is unfortunate because the IASB project plan leaves little room for finalising the Amendments on time even more so for jurisdictions with translation requirements and/or endorsement processes, such as the EU. In addition, modifying IFRS 9 at this moment may create additional uncertainty over the implementation process as some IASB respondents may wish to extend the scope of the Amendments to other topics.

6 Overall, while supporting the narrow-scope Amendments, EFRAG is of the view that the significant efforts that many preparers and early adopters have already taken to implement the Standard should be considered. Hence, EFRAG assesses that the IASB should do its utmost to finalise the changes in the shortest timeframe possible without amending IFRS 9 for other, unrelated, issues.

Question 2

The IASB is expected to amend IFRS 9 to propose that financial assets are eligible for amortised cost measurement or measurement at FVOCI, subject to the business model being met, when:

- the financial asset would otherwise meet the requirements in paragraph B4.1.11(b) of IFRS 9 but does not do so only because the party that terminates the contract early may receive (rather than pay) reasonable additional compensation for doing so; and
- at initial recognition, the fair value of the prepayment feature is insignificant.

Do you agree with these conditions? Why or why not?

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.

7 EFRAG notes that 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.

8 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.

9 EFRAG understands that the proposed Amendments addresses 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 *negative* compensation for the early termination of the contract. Thus, the contract would fail the SPPI-test because of the possibility that the lender may be required to pay (instead of receive) compensation.

10 EFRAG assesses the main issue to be which measurement basis would provide the most useful information to users of financial statements. If the reasonable compensation for early termination of the contract does not significantly affect the effective interest rate at inception, whether the compensation is paid or received by the lender, EFRAG considers that more relevant information is provided by treating the prepayment options under consideration consistently. For the same reason, it will be important that at initial recognition the fair value of the symmetric prepayment option is insignificant. On this basis, EFRAG agrees with the proposed exception.

Question to Constituents

11 Do you agree that contracts where a lender may be required to pay reasonable compensation for early termination (regardless of the party initiating the early termination) should not be prevented from measuring a financial contract at amortised cost or FVOCI if the other conditions for such measurement are met? Please explain.

Question 3 - Effective date

The IASB is expected to propose that the effective date of the exception should be the same as the effective date of IFRS 9, i.e. annual periods beginning on or after 1 January 2018, with earlier application permitted. Do you agree? Why or why not?

The IASB is expected to ask constituents whether they consider a later effective date is more appropriate (with earlier application permitted).

EFRAG's response

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

12 EFRAG is concerned about the short time period between the expected date of issuing the 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 European Union, and it is highly unlikely that such processes can be finalised by 1 January 2018 in all jurisdictions.

13 Therefore, EFRAG strongly supports the IASB providing a later effective date, with earlier 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 when the Amendments apply to them. That is, they would be in the same position as entities that have already adopted IFRS 9.

Question 4 – Transition

The IASB is expected to propose retrospective application for the exception. Do you agree? Why or why not?

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 is first applied.

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

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

15 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. EFRAG therefore considers that, as with many other IFRS Standards, hindsight should not be used in determining whether the fair value of the prepayment feature was insignificant at initial recognition. EFRAG recommends that the IASB provide some transition provisions that address this issue. Such guidance could replicate the relevant transition provision in IFRS 9 for first time adopters or permit the fair value disclosed in the most recent financial statements to be deemed cost for the purposes of measuring amortised cost.

16 EFRAG welcomes any additional guidance for entities who are unlikely to apply IFRS 9 and the proposed Amendments at the same time, for example entities subject to endorsement process or entities that early adopted IFRS 9. EFRAG acknowledges that, without the Amendments, entities might fail the SPPI test under IFRS 9 as it currently stands and accordingly measure these instruments at fair value through profit or loss.

Question to Constituents

17 Do constituents consider that guidance on transition should be provided for entities that have applied or will apply IFRS 9 before they apply the Amendments?

Why or why not?