Prepayment features with Negative Compensation
Issues Paper

Objective

1 The objective of this session is to update EFRAG TEG on the IASB's tentative decisions on the redeliberation of the issues in the IASB Exposure Draft *ED/2017/3 Prepayment Features with Negative Compensation (Proposed amendments to* IFRS 9*)* ('the ED') and to obtain EFRAG TEG's views on these tentative decisions.

Information for EFRAG TEG

2 On 21 April 2017, the IASB issued the ED and on 31 May 2017, EFRAG has published its comment letter in response to the ED.

3 In its comment letter, EFRAG welcomed the IASB addressing the concerns related to prepayment features with negative compensation. In EFRAG's view, the negative sign of the reasonable compensation for early termination should not be the sole reason for preventing measurement of a financial asset at amortised cost or FVOCI.

4 However, EFRAG was of the view that prepayment features with negative compensation should be subject to the same eligibility conditions as prepayment features with positive compensation, i.e. EFRAG agreed with the first eligibility criterion, but not with the second one.

5 In order to minimise any disruption to the implementation efforts already undertaken by preparers and users, EFRAG requested the IASB to do its utmost to finalise the amendments as soon as possible and to ensure they are limited to what is strictly necessary to address the issue submitted to the IFRS Interpretations Committee ('IFRS IC'). Consequently, EFRAG was strongly of the view that the final amendments to IFRS 9 should not be accompanied by references that interpret existing IFRS 9, including the meaning of 'reasonable compensation'.

6 EFRAG recommended that the IASB change the effective date to 1 January 2019, with early application permitted, rather than the date proposed in the ED. Irrespective of whether the effective date is the same time as IFRS 9, EFRAG agreed with retrospective application of the ED.

Comment letters received by the IASB

7 The IASB received 60 comment letters in response to the ED.

8 Most respondents supported the IASB's efforts to address the concerns raised and they agreed that amortised cost measurement provides useful information for the financial assets described in the ED. Many respondents highlighted the urgency of the issue and urged the IASB to finalise the amendments to IFRS 9 as soon as possible.

9 Almost all respondents who answered this question agreed with the first eligibility condition. However, many of these respondents, expressed concern that the Basis for Conclusions on the ED ('the BC') seems to interpret or provide additional guidance on some of the existing requirements in IFRS 9.

10 Respondents had mixed views on the second eligibility condition. While some respondents supported it, more than half of the respondents disagreed with it and recommended that it be deleted. Respondents who agreed with that condition generally supported it because it will ensure that the amendments would have a narrow scope and would target a specific population of financial assets. On the other hand, most of the respondents who disagreed with the second eligibility condition mentioned that the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation.

11 Respondents had mixed views on the proposed effective date. Many respondents agreed with the proposal. However, some respondents, particularly those in jurisdictions with translation and/or endorsement processes, preferred a later effective date; specifically, annual periods beginning on or after 1 January 2019 with early application permitted.

12 Most respondents supported the proposal to require retrospective application of the amendments with the specific provision proposed in the ED. Some respondents who preferred that the effective date of the amendments is later than the effective date of IFRS 9 said that particular transition provisions in IFRS 9 should be made available again when the entity applies the amendments.

Issues for redeliberation

13 At its June 2017 meeting, the IASB considered the feedback from the comment letters on the ED and the issues that need to be discussed in the redeliberation of the proposed amendments to IFRS 9.

14 The following issues have been presented by the IASB staff at the July 2017 meeting.

First eligibility condition

IASB staff analysis

15 Following the feedback from respondents, the IASB staff suggested to confirm the first eligibility condition as it is necessary to ensure that the scope of the amendments targets a specific population of prepayable financial assets; i.e. those 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 that may give rise to reasonable negative compensation for the early termination of the contract.

IASB tentative decisions

16 The IASB tentatively decided to retain the first eligibility condition. All IASB Board members were in favour.

Reasonable compensation for the early termination of a contract

IASB staff analysis

17 The IASB staff noted that the wording in the BC may have been too absolute in its conclusions and acknowledged that a prepayment amount that reflects the instrument's current fair value (or includes the fair value cost to terminate an associated hedging instrument) is not always consistent with a notion of 'reasonable compensation for the early termination of a contract' for the reasons set out in the ED. Therefore, entities cannot automatically presume that all such instruments will

meet the first eligibility condition. Rather entities will need to make that assessment on the basis of the instrument's specific contractual cash flow characteristics.

18 The IASB staff noted that as long as the IASB Board confirms the first eligibility condition, the IASB staff thought that the condition should be reinforced by retaining the explanation in the BC. Such explanation would become particularly important if the second eligibility condition is removed. Therefore, the explanation in the BC related to the notion of 'reasonable compensation for the early termination of the contract' would be critical in order to support the consistent and appropriate application of the first eligibility condition and strengthen entities' understanding of the scope of the amendments.

IASB tentative decisions

19 The IASB tentatively decided to retain and clarify the guidance provided in the BC for 'reasonable compensation for early termination of the contract'. All IASB Board members were in favour.

Second eligibility condition

IASB staff analysis

20 As stated in the BC of the proposed amendments to IFRS 9, the IASB's objective for the second eligibility condition was to limit the scope of the proposals so that financial assets are eligible for amortised cost measurement only if it is unlikely that prepayment, and specifically negative compensation, would actually occur. According to the IASB staff analysis, the second eligibility condition was intended as a straightforward proxy to assess the likelihood of prepayment occurring.

21 The IASB staff noted that the second eligibility condition would, at least in some cases (when the probability of prepayment is high), achieve its objective. That is because the fair value of the prepayment feature would consider the likelihood of prepayment occurring.

22 However, the IASB staff also acknowledged that the second eligibility condition would not achieve its objective in the following cases mentioned by respondents:

(a) when the fair value related to positive compensation and negative compensation were equally significant, then the fair value of the prepayment feature as a whole could be insignificant as they would offset each other. In that case, such instruments would not be restricted from being measured at amortised cost even if the probability of negative compensation arising was high; and

(b) when a financial asset can be prepaid at an amount close to its current fair value because the intrinsic value of such an option would be nil. Again the second eligibility condition, in such circumstances, would not prevent such an instrument from being measured at amortised cost even if the probability of negative compensation occurring was high.

23 Moreover, the IASB staff acknowledged that the second eligibility condition would, in some cases, restrict the amendments in a way that the IASB did not intend. For example, when the fair value of the prepayment feature was more than insignificant largely due to reasonable positive compensation. In those cases, the financial asset may not meet the second eligibility condition even though the holder expects that it is very unlikely that negative compensation will occur. This outcome would be inconsistent with the existing requirements in paragraph B4.1.11(b) of IFRS 9, which do not require a holder to assess the fair value of a prepayment feature that may give rise to reasonable positive compensation.

24 The IASB staff considered other alternatives as an eligibility condition in place of the one proposed in the ED:

(a) insignificant or low probability of negative compensation occurring;

(b) insignificant or low probability of prepayment occurring;

(c) insignificant fair value of a prepayment feature attributable to negative compensation; and

(d) intrinsic value of the prepayment feature.

25 However, the IASB staff identified limitations and challenges on the above alternatives and acknowledged that they were not discussed in the ED and therefore stakeholders did not have the opportunity to comment on them. The IASB staff also acknowledged that complexity would be reduced if the second eligibility criterion was removed, i.e. if accounting for reasonable 'negative' compensation for the early termination of the contract is aligned with the accounting for reasonable 'positive' compensation.

26 As a consequence of removing the second eligibility condition, the IASB staff noted that the existing exception in paragraph B4.1.12 of IFRS 9 would accommodate reasonable negative compensation for the early termination of the contract.

IASB tentative decisions

27 The IASB tentatively decided to remove the second eligibility condition proposed in the ED and the proposed transition provision and disclosure requirement related to that condition. All IASB Board members were in favour.

Effective date and transition

IASB staff analysis

28 The IASB staff suggested that the amendments are mandatorily effective for annual periods beginning on or after 1 January 2019 (with early application permitted) to allow sufficient time for endorsement and translation processes. As the amendments are applied retrospectively, the effective date could have consequences on transition for entities that applies the amendments for the first time after it applies IFRS 9, therefore the IASB staff proposed that such entities would:

(a) apply the relevant transition provisions in Section 7.2 of IFRS 9 to financial assets that are affected by the amendments specifically with regards to the fair value option and the effective interest rate method, as the transition provisions in IFRS 9 would not be applicable when the entity applies the amendments;

(b) not be required to restate prior periods to reflect the amendments, and could choose to do so only if it is possible without the use of hindsight; and

(c) would be required to provide particular transition disclosures.

IASB tentative decisions

29 The IASB tentatively decided to:

(a) set an effective date of 1 January 2019, with earlier application permitted; and

(b) require retrospective application of the amendments with transition relief as described in paragraph 28 above for entities that apply IFRS 9 before applying the amendments.

30 All IASB Board members were in favour.

Modifications or exchanges of financial liabilities

Introduction

31 The IFRS IC received a request to clarify whether an entity recognises a gain or loss in profit or loss when a financial liability is modified or exchanged and that modification or exchange does not result in the derecognition of the financial liability.

32 This issue was first discussed at the IFRS IC meeting in November 2016 which at that moment proposed to develop a draft Interpretation. The IASB Board was asked whether they agreed with the release of a draft Interpretation in February 2017. At that meeting, the IASB Board objected to the release of an Interpretation and concluded that no standard setting was required. Instead, other means should be used to highlight the relevant accounting. That IASB Board decision was discussed at the IFRS IC meeting in March 2017.

33 In March 2017, the IFRS IC issued a tentative agenda decision as follows:

> *The Committee noted that the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in the derecognition of the financial liability. This is consistent with the requirements in IFRS 9 for modifications of financial assets that do not result in derecognition, and with the definition of amortised cost in Appendix A of IFRS 9 that applies to both financial assets and financial liabilities.*
>
> *The Committee concluded, therefore, that an entity applies paragraph B5.4.6 of IFRS 9 to a modification or exchange of a financial liability that does not result in the derecognition of the financial liability. In doing so, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange.*
>
> *The Committee noted that IFRS 9 had introduced additional wording in paragraph 5.4.3 of IFRS 9 on the accounting for modifications of financial assets. The Committee observed that, if an entity changes its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition as a result of the initial application of IFRS 9, then the entity applies the transition requirements in IFRS 9, which require retrospective application subject to particular relief as specified in Section 7.2 of IFRS 9.*
>
> *The Committee concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.*

34 In June 2017, the IFRS IC discussed the comments received on the tentative agenda decision published in March 2017. While agreeing with the technical analysis summarised in the tentative agenda decision, in the light of the comments received, the IFRS IC decided not to finalise the agenda decision and instead referred the matter to the IASB Board.

IASB staff analysis on some[1] of the concerns

Applying paragraph B5.4.6 of IFRS 9 to modifications and exchanges of financial liabilities

Respondents' comments to the IFRS IC

35 Some constituents noted that an exchange or modification is different from a revision of estimates of payments or receipts that occurs according to the original (unmodified) contractual terms of a financial instrument. Consequently, the two cases should be analysed separately and possibly result in different accounting. One constituent noted that entities should have an accounting policy choice because it is not clear whether paragraph B5.4.6 of IFRS 9 applies to a modification or exchange of a financial liability that does not result in the derecognition of the liability.

36 Respondents also noted that applying paragraph B5.4.6 of IFRS 9 to a modification of the interest rates charged does not represent the substance of the transaction, i.e. the relevance or economic rationale of the immediate effect on profit or loss is not understood. Some respondents noted that a change in interest rate would be more faithfully represented by the recognition of an increased or decreased interest expense over the remaining life of the borrowing, rather than by the recognition of a gain or loss at the time of the modification and continued recognition of interest expense at the original effective interest rate.

IFRS IC comments and IASB staff analysis

37 The IFRS IC noted that the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in the derecognition of a financial liability. Some respondents disagreed with this.

38 However, the IFRS IC noted that, upon modification, a modified financial liability continues to be the same original financial liability (if it is not derecognised). Consequently, there is no basis on which to distinguish the accounting for changes in cash flows that arise from revisions of estimates from the accounting of cash flows that arise from modifications. Hence, for both purposes an entity remeasures the amortised cost of the financial liability by using the financial instrument's original effective interest rate.

The treatment of modified cash flows versus costs and fees incurred

Respondents' comments to the IFRS IC

39 Some respondents wanted further clarification explaining how paragraphs B5.4.6. and B3.3.6 of IFRS 9 interact and pointed out that in absence of such guidance, the interaction between the two will remain problematic and prone to structuring opportunities.

IFRS IC comments and IASB staff analysis

40 The IFRS IC noted that an entity recognises any adjustment to the amortised cost of a modified financial liability in profit or loss as income or expense at the date of the modification of exchange. In contrast, paragraph B3.3.6 of IFRS 9 requires that any costs and fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the financial liability.

41 The IASB staff advised not to address the difference in treatment between fees and costs incurred on the one hand and treatment of modified cash flows on the other hand. This because it is outside the scope of the question submitted and whether

[1] Note that the issue whether the derecognition requirements for financial liabilities require only a quantitative assessment (the 10 percent test) or whether qualitative factors must also be considered is now part of a separate workflow.

those requirements should be aligned is a broader issue than the one addressed in the tentative agenda decision.

Transition

Respondents' comments to the IFRS IC

42 Some respondents wanted specific transition provisions because retrospective application may be complex. It was noted by one respondent that transition may require the reversal of changes made to the effective interest rate, which in turn may affect the outcome of the entity's analysis of whether subsequent modifications or exchanges result in derecognition. A further comment was that a transition relief based on impracticability was not workable as the threshold for impracticability was too high.

IFRS IC comments and IASB staff analysis

43 The IFRS IC noted that if an entity changes its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition as a result of the entity's initial application of IFRS 9, then the entity applies the transition requirements in IFRS 9, which require retrospective application subject to particular specified relief.

44 The IASB staff thinks that transition for this issue should be the same as the overall approach for applying IFRS 9 because they see no compelling case for an exception in this case.

45 The IASB staff acknowledges there is insufficient time for an entity to apply retrospectively a change in its accounting policy for modifications or exchanges of financial liabilities that do not result in derecognition before the effective date of IFRS 9. By incorporating the issue in the proposals for '*Prepayment Features with Negative Compensation'*, the implementation deadline becomes 1 January 2019, with earlier application permitted.

How to highlight the relevant accounting

46 Respondents to the tentative agenda decision noted that in practice there is a common understanding that the requirements for liabilities (including any modifications) are largely unchanged between IFRS 9 and IAS 39. This contrasts with the earlier view of the IASB Board that the requirements of IFRS 9 provide an adequate basis to account for modifications and exchange of financial liabilities that do not result in derecognition, hence standard setting is not required.

47 Initially, the IASB Board considered using a webcast to explain the relevant accounting, in addition to the IFRS IC agenda decision. However, a majority of respondents to the tentative agenda decision preferred an authoritative mechanism.

48 Following the decision of the IFRS IC to refer the matter back to the IASB Board, the IASB is now proposing to take advantage of the work done for '*Prepayment Features with Negative Compensation (Proposed Amendments to IFRS 9)*' to explain, in the BC, the accounting requirements for modifications.

EFRAG Secretariat analysis

First eligibility condition

49 The EFRAG Secretariat agrees with the IASB tentative decision on retaining the first eligibility condition as this was the view expressed in EFRAG's comment letter.

Reasonable compensation for the early termination of a contract

50 The EFRAG Secretariat notes that the tentative decision taken by the IASB is to retain and clarify the notion of 'reasonable additional compensation' in the BC and that entities should make their assessment of this notion on the basis of the

instrument's specific contractual cash flow characteristics. The EFRAG Secretariat points out that this is in contradiction with EFRAG's comment letter.

Second eligibility condition

51 The EFRAG Secretariat agrees with the IASB tentative decision to remove the second eligibility condition, as this was the view expressed in EFRAG's comment letter in response to the ED.

Effective date and transition

52 Consistent with the view expressed in EFRAG's comment letter, the EFRAG Secretariat supports the IASB tentative decision on the effective date of 1 January 2019, with earlier application permitted, and the additional transitional arrangements for entities that apply the amendments for the first time after applying IFRS 9.

Modifications or exchanges of financial liabilities

53 The EFRAG Secretariat agrees with the technical analysis of the IASB staff. However, for due process reasons and while acknowledging that the BC is not endorsed in Europe, the EFRAG Secretariat does not support the proposal to explain the issue in the BC of the amendments to IFRS 9 that relate to *Prepayment Features with Negative Compensation*.

54 The many comments received by the IFRS IC demonstrate that the issue is controversial. The IASB Board has made it clear that no standard setting is required, in which case the EFRAG Secretariat sees no need to incorporate guidance in the BC of the amendments to IFRS 9.

55 In addition, the EFRAG Secretariat points out that the IFRS IC discussion also included a discussion on whether the derecognition requirements for financial liabilities require only a quantitative assessment (the 10 percent test) or whether qualitative factors must also be considered. The EFRAG Secretariat understands that this is now part of a separate workflow for which an Exposure Draft is to be released as part of the annual improvements process. The proposed amendment would clarify the requirements in the first sentence of paragraph B3.3.6 of IFRS 9. The amendment will say that when carrying out the '10 per cent' test for assessing whether to derecognise a financial liability, an entity includes only fees paid or received between the entity and the lender, including fees paid or received by either the entity or the lender on the other's behalf.

Questions for EFRAG TEG

With the aim of preparing for a draft endorsement advice on the future amendment:

56 Does EFRAG TEG agree with the IASB's tentative decisions about the first and second eligibility conditions?

57 Does EFRAG TEG agree with the IASB's tentative decision to add an explanation in the BC on the notion of 'reasonable compensation for the early termination of the contract'?

58 Does EFRAG TEG agree with the IASB's tentative decisions about the effective date and transitional arrangements?

59 Does EFRAG TEG have comments on the IASB decision to explain the accounting for modifications or exchanges of financial liabilities in the BC of the upcoming IFRS Standard?