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EFRAG
European Financial Reporting Advisory Group

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

Feedback to constituents – EFRAG Final Comment Letter

May 2017

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

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Introduction

Objective of this feedback statement

The IASB published its Exposure Draft ED/2017/1 *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9)* ('the ED') on 21 April 2017. This feedback statement summarises the main comments received by EFRAG on its draft comment letter and explains how those comments were considered by EFRAG during its technical discussions leading to the publication of EFRAG's final comment letter.

Background to the ED

The ED proposed a narrow-scope amendment to IFRS 9 *Financial Instruments* so that a financial asset that would otherwise meet the SPPI condition in IFRS 9 but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity, is eligible to be measured at amortised cost or fair value through other comprehensive income ('FVOCI') (subject to meeting the business model condition) if:

- 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.

Further details are available on the EFRAG website.

EFRAG's draft comment letter

EFRAG published a draft comment letter on the proposals on 4 May 2017. In the draft comment letter, EFRAG considered that financial instruments containing prepayment features with negative compensation could be eligible for measurement at amortised cost or at FVOCI. In EFRAG's preliminary 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.

EFRAG considered that prepayment features with negative compensation should be subject to the same eligibility conditions as

prepayment features with positive compensation. As a result, EFRAG agreed with the first eligibility criterion proposed in the Amendments but not with the second one, which states that the fair value of the prepayment feature should be insignificant at initial recognition. Given that the Amendments were being developed on a fast track timetable, EFRAG questioned whether the IASB has or will be able to obtain sufficient evidence of the types of instruments that would be excluded by the second criterion and whether those outcomes were appropriate.

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'. Any such references might affect the accounting treatment of other financial instruments, which is beyond the scope of the proposed amendments.

Lastly, EFRAG recommended that the IASB include an effective date of 1 January 2019, with early application permitted, rather than the date proposed in the Amendments. If the proposed Amendments can be applied at the same time as IFRS 9, EFRAG agreed with applying them retrospectively.

Comments received from constituents

EFRAG has received and considered 9 comment letters from constituents. These comment letters are available on the EFRAG website.

The comment letters received came from national standard setters, preparers and preparer organisations.

Summary of respondents' comments

None of the respondents disagreed that the issue of prepayment features with negative compensation is to be addressed. Two respondents noted that the issue could be addressed by a clarification instead an amendment to IFRS 9. One respondent disagreed with this.

Three respondents provided examples of the sectors and types of loans where such instruments are seen. One respondent noted that they were not aware that such instruments were widespread in their jurisdiction, while another observed that the use of symmetric clauses is widespread to justify an amendment to IFRS 9.

Six respondents agreed with the first eligibility criterion. Others did not specifically comment on the question.

Seven respondents agreed with EFRAG's proposal to remove the second eligibility criterion and two did not agree.

Six respondents also supported EFRAG's view that the final amendments to IFRS 9 should not be accompanied by references that interpret existing IFRS 9, while one stated that the ED should be finalised in its current form. Others did not specifically comment on the question.

Four respondents were of the view that the Amendments should be applied at the same time as IFRS 9, i.e. at 1 January 2018, while one respondent agreed with EFRAG's tentative position. Three respondents noted that deferral of the application date to January 2019 does not resolve the double change in the accounting treatment of financial assets with symmetrical prepayment features.

In addition, four respondents demanded that the endorsement process is done fast enough in order to avoid successive changes in measurement of financial assets with negative compensation.

Two respondents asked the IASB to consider additional transitional reliefs.

EFRAG's proposed final comment letter

EFRAG issued its final comment letter on XX May 2017.

EFRAG's proposed final comment letter is identical to the draft version, with one exception. The reason for proposing a transition date at 1 January 2019 is explained in more detail. The added text explain how a later tentative date, with earlier application permitted, may address the situation for entities submitting IFRS financial statements in the US and the EU.

Detailed analysis of issues, comments received and changes made to EFRAG's final comment letter

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Addressing the concerns raised

Proposals in the ED

After IFRS 9 was issued, the IFRS IC received a submission questioning how to classify particular prepayable financial assets when applying IFRS 9. In the instruments described in the submission, the lender could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. Such a prepayment amount would, in effect, include an amount that reflects a payment to the borrower by the lender (instead of compensation from the borrower to the lender) even though the borrower chose to terminate the contract early. Applying IFRS 9, those contractual cash flows are not SPPI, and therefore the financial assets would be measured at fair value through profit or loss.

IFRS IC members suggested that the IASB consider whether using amortised cost measurement could provide useful information about particular financial assets with such prepayment features, and if so, whether the requirements in IFRS 9 should be changed in this respect.

In the light of the IFRS IC recommendation and similar concerns raised by banks and their representative bodies in response to IFRS IC discussion, the IASB decided to propose a narrow exception to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are SPPI but do not meet that condition only as a result of a prepayment feature. Applying the proposals, such financial assets would be eligible to be measured at amortised cost or at FVOCI, subject to the

Proposed EFRAG's response to respondents' comments

Proposed EFRAG final position

Based on the comments from respondents, EFRAG did not change the position in its draft comment letter.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

assessment of the business model in which they are held, if particular conditions are met.

EFRAG's tentative position

EFRAG welcomed the IASB addressing the concerns related to prepayment features with negative compensation as it will clarify the accounting for financial instruments that incorporate prepayment features with negative compensation. Based on EFRAG's initial outreach, prepayment features with negative compensation exist in different types of loans in various jurisdictions across Europe.

Respondents' comments

None of the respondents opposed that the concerns relating to prepayment features with negative compensation should be addressed.

One respondent did not agree with EFRAG's view that the objective of the amendment could be achieved through a clarification instead of an amendment of IFRS 9. They believed that the option to measure financial instruments with a negative compensation feature at amortised cost or FVOCI is an exception to the SPPI-criterion. In contrast, two respondents are of the view that it can be addressed by issuance of a clarification instead of an amendment.

In its draft comment letter, EFRAG asked constituents to provide examples about financial instruments with prepayment features with negative compensation.

Not all respondents provided information about the occurrence of prepayment features with negative compensation. One respondent provided a general comment that the use of prepayment features with negative compensation were widespread enough. Three respondents

Proposed EFRAG's response to respondents' comments

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

provided more detail. They noted that such features occurred in i) the UK Social Housing Sector; ii) aircraft industry financing or asset based financings for large corporates and iii) in loans to private mortgage borrowers which are allowed only to prepay if they sell their property. One respondent noted that they are not aware that such instruments are widespread enough in their jusrisdiction.

The proposed exception

Proposals in the ED

The ED 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 ED 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:

- 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.

EFRAG's tentative position

First eligibility criterion

Proposed EFRAG's response to respondents' comments

Proposed EFRAG final position

Based on the comments from respondents, examples were provided where criterion 2 could restrict the measurement of certain financial assets at amortised cost or FVOCI, consequently, EFRAG did not change the position in its draft comment letter.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**Proposed EFRAG's response to respondents' comments**
EFRAG supported the proposal that financial instruments containing prepayment features with negative compensation could be eligible for measurement at amortised cost or at FVOCI. EFRAG considered that the existence of either a positive or a negative compensation element in the prepayment amount should not in isolation prevent the instrument qualifying as SPPI, provided that the compensation element is reasonable. EFRAG therefore agreed with the first eligibility criterion.	
Second eligibility criterion	
EFRAG disagreed with the second eligibility criterion. EFRAG was of the view that the eligibility criteria for prepayment features with negative compensation should be aligned with those for prepayment features with positive compensation.	
EFRAG was concerned that this second criterion will overly restrict the eligibility of instruments with negative compensation features for measurement at amortised cost or FVOCI. Moreover, given that the proposals are being developed on a fast track timetable, EFRAG questioned whether the IASB had or would be able to obtain sufficient evidence of the types of instrument that would be excluded by the second criterion and whether those outcomes are appropriate.	
Other comments	
EFRAG considered that the proposals should not be accompanied by references that interpret existing guidance in IFRS 9, including the meaning of 'reasonable compensation'. Any such reference might affect the accounting treatment of other financial instruments, which is beyond the scope of the proposals in the ED.	
Respondents' comments	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Proposed EFRAG's response to respondents' comments

First eligibility criterion

Six respondents agreed with the first eligibility criterion. The EFRAG Secretariat expects also to receive the following comment from one respondent. That respondent disagreed with the assessment of the IASB that the 'reasonable additional amount' reflects (only) the effect of a change in market interest rate and the conclusion that instruments with compensation for (only) interest rate changes should be eligible for amortised cost measurement while those with a fair value compensation should not. This respondent believed that it would be far more appropriate to link the prepayment amount to the underlying loan agreement features satisfying the SPPI-test, i.e. the additional compensation must bear a logical relationship to the terms of the initial loan agreement, such that any amounts to be paid or received under the prepayment feature must relate to changes in factors inherent in or closely related to the loan agreement (the former covering risk factors such as interest, credit and liquidity, the latter covering margins as well as unavoidable costs due the dissolution of hedges and administration.

Second eligibility criterion

In its draft comment letter, EFRAG asked constituents to provide evidence of financial instruments with prepayment features with negative compensation that would not pass the SPPI-test, while similar financial instruments with positive compensation would pass the SPPI-test. In addition, EFRAG asked whether removing the second eligibility criterion would result in a more appropriate measurement of financial instruments with negative compensation.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	Proposed EFRAG's response to respondents' comments
Seven respondents did not agree with the second eligibility criterion, i.e. agreeing with EFRAG's tentative view. Two respondents explicitly agreed with the second eligibility criterion. Reasons provided for rejecting the second eligibility criterion were that prepayment features with negative compensation should be subject to the same eligibility criteria as prepayment features with positive compensation. Also, it could seriously limit the scope of the financial instruments concerned. Another reason mentioned were the difficulties in determining the fair value of a prepayment feature. One respondent noted that although the cash flows of the instruments may pass the SPPI, the prepayment option may have some value at inception based on the probability of prepayment occurrence. That respondent also observed that if the aim of the IASB were to prevent embedded derivatives that would make the instrument depart from a basic lending agreement, then such instruments would already fail the first eligibility criterion. One respondent suggested that, as an alternative, the second criterion should be reworded to refer only to the unlikeliness that prepayment will occur instead of referring fair value of the prepayment option. The aim would be the same, namely avoiding recognising at amortised costs instruments subject to frequent catch up adjustments, without introducing additional complexities, while more faithfully representing the economic reality of these transactions. One respondent indicated that the most frequent case of financial instruments that would fail SPPI because of the second eligibility criterion exist in fixed rate loans where the prepayment amount is computed as the residual principal plus the breakage cost to unwind a vanilla interest rate	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**Proposed EFRAG's response to respondents' comments**
swap hedging in interest rate component of the loan. They acknowledged that these loans could be seen as having an embedded credit derivative, as the borrower could be regarded as having an incentive to exercise its option if its credit spread improves and as a consequence, the fair value of the prepayment feature might not be insignificant. The respondent believed that demonstrating whether the fair value of the prepayment feature is insignificant could be challenging, if not impossible, even if in practise these options are rarely exercised. In their view, the sole fact that these options are rarely exercised should be sufficient to allow an amortised cost accounting for these loans. Another respondent provided the example of prepayment provisions that allow the borrower to early prepay by discounting the remaining cash flows using the new current benchmark rate with the initial credit spread. This instrument may not pass the second eligibility criterion, because such prepayment option has some value for the borrower since it allows benefiting from better credit spread conditions. In contrast, one respondent who believed that the second eligibility criterion was appropriate did not agree with the views expressed by others that feed into the current draft EFRAG letter that including this second criterion is too restrictive, could have unintended consequences, create complex operational challenges and disruption. Proving a feature has insignificant fair value is not new with IFRS 9 already incorporating a similar requirement in B4.1.12 and is not something that should be debated at this late stage on a technical basis. They added that suggestions to the IASB to remove the second eligibility criterion might result in the IASB replacing the wording with something more restrictive such as a consideration of the likelihood of exercise. *Interpreting existing IFRS 9*	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**Proposed EFRAG's response to respondents' comments**
Six respondents supported EFRAG's 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. The remaining respondents did not comment on that point. One respondent added that deletion of the draft guidance may not be enough, as it may already have created a precedent on how IFRS 9 is to be interpreted. Therefore, the IASB should respond to the criticism, reconsider the usefulness of the guidance and delete the most disruptive sections. One respondent questioned the amount on which additional compensation should be based on i.e. the outstanding principal including the whole outstanding interest payments or only the outstanding principal including the outstanding interest payment until the point termination.	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Effective date and transition

Proposals in the ED

Effective date

The ED 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, due to the significant benefits if entities initially apply IFRS 9 taking into account the effect of the proposed exception. If an entity applies those Amendments for an earlier period, it shall disclose that fact.

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.

Transition

The ED proposes that the exception would be applied retrospectively, subject to a specific transition provision if doing so is impracticable.

The ED does not propose any specific transition provisions for entities that apply IFRS 9 before they apply the exception.

EFRAG's tentative position

Effective date

EFRAG supported a later effective date of 1 January 2019, with early application permitted. This will allow jurisdictions with translation and/or

Proposed EFRAG's response to respondents' comments

Proposed EFRAG final position

Based on comment from respondents, EFRAG continued to recommend that the effective datebe 1 January 2019 but explained in more detail the reason for transitioning at that date. The added text explained how a later tentative date, with early application permitted, may address the situation for entities submitting IFRS financial statements in the US and the EU.

EFRAGacknowledged the concerns raised by respondents about the endorsement process but there can be noguarantee of a timely endorsement for an amendment that will be issued a few months before its first application date.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**Proposed EFRAG's response to respondents' comments**
endorsement processes to finalise such processes before the mandatory effective date, while the possibility to early apply the amendments provides preparers with the ability to implement soon after finalisation of any translation or endorsement process. *Transition* Assuming that the proposed amendments are applied at the same time as IFRS 9, EFRAG agreed that they should be applied retrospectively. EFRAG also considered that the normal transition requirements of IFRS 9 will cater for entities applying the amendments at the same time as first applying IFRS 9. If the IASB agrees with a later effective date of 1 January 2019 (with early application permitted), EFRAG saw no need for transition requirements beyond those proposed in the ED. EFRAG acknowledged that applying the amendments later than the effective date of IFRS 9, should entities be unable or unwilling to apply them early, may give rise to communication as well as implementation issues. However, under EFRAG's recommendation the delay would only be one year. EFRAG also noted that entities are required to disclose certain information for IFRS Standards that were issued but are not yet effective which the entity has not yet applied. This disclosure should somewhat mitigate the potential communication issues. *Respondents' comments* *Effective date* Four respondents were of the view that the Amendments should be applied at the same time as IFRS 9, i.e. at 1 January 2018. One respondent agreed with EFRAG that the IASB set the effective date at 1	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**Proposed EFRAG's response to respondents' comments**
January 2019 with early application permitted. One respondent observed that an effective date of 1 January 2018 is likely to create issues for foreign filers. Three respondents noted that deferral of the application date to January 2019 does not resolve the double change in the accounting treatment of financial assets with symmetrical prepayment features. Hence, they urge the endorsement process to be finalised before 1 January 2018. Four respondents noted that the endorsement process needed to be finalised before 1 January 2018 or at the end of the first quarter of 2018. *Transition* Two respondents asked the IASB to consider additional transitional reliefs.	

Appendix 1: List of respondents

Table 1: List of respondents

Name of constituent[1]	***Country***	***Type / Category***
International Swaps and Derivatives Association, Inc. ('ISDA')	United Kingdom	Preparer organisation
Febelfin	Belgium	Preparer organisation
GDV	Germany	Preparer organisation
FRC	United Kingdom	Standard Setter
European Savings and Retail Baking Group ('ESBG')	Europe	Preparer organisation
BNP Paribas ('BNPP')	France	Preparer
European Banking Federation ('EBF')	Europe	Preparer organisation
Comissao de Normalizacao Contabilistica ('CNC')	Portugal	Standard Setter
UBS	Switzerland	Preparer

1 Respondents whose comment letters were considered by the EFRAG Board before finalisation of the comment letter.

Appendix 2: Summary - respondents by country and by type

Table 2: Total respondents by country and by type

Respondent by country:		***Respondent by type:***	
Belgium	1	Standard Setters	2
UK	2	Preparers	2
Europe	2	Preparer organisations	5
France	1		
Portugal	1		
Germany	1		
Switzerland	1		
	9		9