


POSITION PAPER



ESBG response to the EFRAG consultation on Prepayment features with negative compensation (Proposed amendments to IFRS 9)

ESBG (European Savings and Retail Banking Group)

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ESBG Transparency Register ID 8765978796-80

May 2017



ESBG thanks EFRAG for the opportunity to provide its comments on the proposed amendments to IFRS 9 relating to the Prepayment Features with Negative Compensation, on the basis of the endorsement advice that EFRAG will provide to the European Commission.

We would like to attract your attention to the following key points, which are of particular importance to ESBG's members:

1. **Eligibility criteria:** We disagree with § B4.1.12A (b) that provides an additional criterion which restricts the scope of that exception to prepayment features the fair value of which is “insignificant” “initially” for the party recognising an “asset”: **B4.1.12A (b) should be deleted.**
2. **Effective date:** **The amendment should be endorsed and become applicable in the EU from 01/01/2018.** It is crucial that the implementation date of the amendment in the EU be 01/01/2018 and not later.
3. **Basis for conclusion:** The Basis for Conclusion that goes beyond the scope of the amendment should, in our opinion, be deleted (BC 18 in particular).

Responses to the Draft Comment Letter from EFRAG (dated May 3rd, 2017)

Question 1 – Addressing the concerns raised

IASB Question to constituents

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 IASB should seek to address these concerns? Why or why not?

ESBG welcomes the IASB addressing the concerns related to prepayment features with negative compensation, as it will provide clarification on the accounting for financial instruments that incorporate prepayment features with negative compensation.

ESBG considers that modifying IFRS 9 Financial Instruments a few months before its implementation may negatively affect the significant implementation efforts already undertaken by many preparers (including early adopters) and by users. ESBG therefore requests that the utmost should be done to finalise the Amendments and endorse them in the EU as soon as possible.

EFRAG Question to constituents

EFRAG's initial outreach revealed that prepayment features with negative compensation exist in different types of loans in various jurisdictions across Europe. Do you agree that the issue is widespread enough that the IASB should amend IFRS 9 so close to its effective date? Why or why not? Please explain and provide examples where possible.

ESBG agrees that the use of symmetric clauses is widespread enough and that the IASB should amend IFRS 9. Examples have been shared and discussed with EFRAG.



Question 2 – The proposed exception
IASB Question to constituents

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 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?

Eligibility criteria

ESBG agrees with EFRAG's preliminary view that 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. ESBG therefore welcomes the amendment introduced in § B4.1.12A (a) which introduces an exception to the SPPI test defined in § B4.1.10 for contracts with negative compensation.

Furthermore, ESBG disagrees with § B4.1.12A (b) that provides an additional criterion which restricts the scope of that exception to prepayment features the fair value of which is “insignificant” “initially” for the party recognising an “asset” (i.e. the holder) for the following reasons:

- Prepayment provisions that allow the borrower to early prepay their borrowing by discounting the remaining cash flows using the new current benchmark rate with the initial credit spread may not pass the criteria described in B4.1.12A(b) because such prepayment option has some value for the borrower since it allows benefiting from better credit spread conditions. We believe such prepayment should meet the exception criteria since the amount being paid by the borrower represents the time value of money (discount value of the remaining cash-flows)
- If the aim of the board is only to prevent embedding derivatives that would make the instrument depart from a basic lending arrangement, we believe that such instruments would also have failed the SPPI test in § B4.1.11(a).

To conclude, ESBG agrees with EFRAG regarding the first eligibility criterion but not with the second one. In our view, the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation.

Furthermore, we note that although the resulting cash flows of the instrument may only be principal and interest payments, the prepayment option may have at inception some value based on the probability of occurrence of the prepayment. This expected probability will not always be zero or very unlikely at inception. However, payments that compensate any party for the change in the economic value of the interest that would have been accrued should pass the SPPI test.

Briefly, the clause B4.1.12A (b) should be deleted.



Basis for conclusion

With regards to the potential spill-over effect, in our view, the Basis for Conclusion that goes beyond the scope of the amendment should be deleted (BC 18 in particular).

ESBG also believes the final amendments to IFRS 9 should not be accompanied by references that interpret existing guidance in 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.

In this respect, ESBG is very concerned that the interpretations of existing IFRS 9 proposed in the Basis for Conclusions of the Amendments may affect the implementation work of preparers by obscuring, rather than clarifying, the understanding of the standard just a few months before its first application

EFRAG question to constituents

Do you have evidence of financial assets with prepayment features with negative compensation that would not qualify as SPPI based on the eligibility criteria as proposed in the Amendments? If so, do you consider this outcome to be appropriate or inappropriate? Please explain and provide examples where possible.

EFRAG question to constituents

Would EFRAG's suggestion to remove the second eligibility criterion result in a more appropriate measurement of financial assets with prepayment features with negative compensation? Please explain and provide examples where possible.

Yes, ESBG is of the opinion that removing the second eligibility criterion will result in a more appropriate measurement of financial assets with prepayment features with negative compensation.

We totally agree that instruments (as described in paragraphs BC14-BC16 of the Exposure Draft), where the additional compensation depends only on the movement in the relevant market interest rate, should be eligible instruments to be measured at amortised cost under IFRS 9. Such instruments do not introduce any contractual cash flows different from principal and interest: in all cases, the prepayment amount reflects those unpaid amounts of principal and interest plus (or minus) an amount to reflect the effect of the change in the relevant market interest rate. The latter amount should be considered as reasonable as it is the amount that would make the bank indifferent between having or not having the prepayment.

Question 3 – Effective date

IASB Question to constituents

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?

Notwithstanding the fact that there is limited time between the expected date of issuing the proposed Amendments and the proposed effective date of 1 January 2018, **ESBG is strongly of the view that the proposed Amendments must be applied at the same time as IFRS 9. It is therefore imperative that the effective date of the amendment be 1 January 2018.**



ESBG considers that modifying IFRS 9 Financial Instruments a few months before its implementation may negatively affect the significant implementation efforts already undertaken by many preparers (including early adopters) and by users. ESBG therefore requests that the utmost should be done to finalise the Amendments and endorse them in the EU as soon as possible.

If the IFRS 9 amendment is to become effective at a later stage than IFRS 9, this will create inconsistencies in the measurement of financial instruments that contain prepayment features with negative compensation. In particular, entities first applying IFRS 9 in 1 January 2018 will need to measure the financial instruments containing prepayment features with negative compensation at fair value through profit or loss. Upon the adoption of IFRS 9 amendments at a later stage, entities will have to change the measurement of those financial instruments to amortised cost or FVOCI. Such a change in measurement for certain financial assets within a time-frame of a few months will raise questions from users of financial statements, and require specific communication efforts as well as duplicate work and effort from preparers.

In addition, we are worried about EFRAG's assumption that the endorsement of the amendments before the end of the first quarter of 2018 suits European entities. The reason being that many preparers issue their financial statements in January/February, thus an endorsement close to the end of the first quarter of 2018 will come too late.

Therefore, only an endorsement before 2018 year-end will ensure that the necessity of having two different treatments for these instruments will be avoided. ESBG believes that the financial instruments should be measured consistently since the initial application of IFRS 9.

For these reasons, ESBG requests that the utmost be done to finalise the Amendments and endorse them in the EU as soon as possible.

Question 4 – Transition

IASB Question to constituents

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.

- **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 Exposure Draft 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?



About ESBG (European Savings and Retail Banking Group)

ESBG – The Voice of Savings and Retail Banking in Europe

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.



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Published by ESBG. [Date]