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Comments on EFRAG Draft comment letter on Prepayment Features with Negative Compensation

We are pleased to provide BNP Paribas' comments on **EFRAG Draft Comment letter on the proposed amendment to IFRS 9 *Prepayment Features with Negative compensation.***

First of all we welcome the efforts and work accomplished by EFRAG and IASB towards understanding the concerns raised by the industry and getting a solution for prepayment features with negative compensation.

We fully support the EFRAG Draft Comment letter on the proposed amendment to IFRS 9 Prepayment Features with Negative compensation, and the recommendation to remove the second criterion of the exception introduced by § B4.1.12 A, for the reasons explained below.

Context

In the actual macro-economic environment, European banks provide fixed rate loans with prepayment option settled with fair value or symmetrical prepayment compensation. These loans are marketed to answer clients demand for fixed rate loans.
The prepayment provisions are explicitly required by well-informed clients and are intended to provide them with fairer conditions in unexpected prepayment situations rather than to introduce a leverage feature in their loans.
Such loan features represent a significant part of specialized financing as the aircraft industry financing for instance. They also are a common market practice for other asset based financings of large corporates.

While we fully appreciate the efforts made by the IASB, we have two main concerns:

- The Basis for Conclusions of the proposed amendments introduce some elements of guidance, which go beyond the scope of the issue raised, on the interpretation of the SPPI concept, the EIR and amortised cost measurement or the "reasonable additional compensation" concept. At this late stage of the implementation, this constitutes a real concern for preparers.

  The Basis for Conclusions of this ED state for example that the current fair value is not a reasonable compensation for the early termination of the contract (cf. notably BC18), thus introducing new guidance on the notion of reasonable compensation.

  For these reasons, we share EFRAG's concerns expressed in its draft comment letter that these references in the Basis for Conclusions go beyond the scope of the issue that was submitted to the IFRS Interpretations Committee and that the Amendment is intended to address.

- While we fully understand the concern of the IASB to narrow the scope of instruments eligible to the amendment, we are concerned by the second criterion which requires that the fair value of the prepayment option is insignificant initially for the holder, for the reasons detailed below:

  – We understand that the main objective of this second criterion is to limit the scope of the proposed exception to instruments for which prepayment is unlikely to occur, to make sure that eligible instruments would not be subject to frequent "catch up" adjustments (which would be seen as inconsistent with an amortised cost classification). A prepayment option would have an insignificant fair value at any time only if the instrument is repayable at its fair value (in which case there would be no "catch up" adjustments). However, as mentioned above, the proposed amendment states that a fair value amount is not a "reasonable compensation" and thus instruments repayable at fair value would not meet the Solely Payment of Principal and Interest criteria and would not be eligible to amortised cost. As a consequence, almost no instrument in practise would be eligible to this narrow scope amendment.

    For fixed rate loans with symmetric prepayment penalties, the most frequent case is where the prepayment amount is computed as the residual principal plus the breakage cost to unwind a vanilla interest rate swap hedging the interest rate component of the loan. This is meant to be a proxy of the "interest rate differential" calculation. 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.

    Thus, the demonstration that the fair value of the prepayment feature is insignificant could be challenging, if not impossible, even if in practise these options are rarely exercised. The sole fact that these options are rarely exercised should be sufficient to allow an amortised cost accounting for these loans.

    Besides, we do not see the rationale for adding this second criterion for prepayment features with negative compensation. For an asymmetric compensation, there is no need to demonstrate that the fair value of the prepayment option is insignificant, even if in theory a loan with such asymmetric clauses could be subject to a prepayment, if the credit spread of the borrower improved.

- These loans, whether they are with symmetric or asymmetric compensation amounts are clearly originated or purchased in a hold-to-collect business model, without any leverage. Potential compensation amounts only represent the present value of interest which consists of consideration for the time value of money, credit risk associated with the principal amount outstanding and other basic lending risks and costs as well as margin.
- Besides, we do not understand why the conditions for the exceptions in paragraphs B4.1.12 (acquisition at a premium or discount to the contractual amount) and new B4.1.12A should be mutually exclusive. Pre-payable financial assets with negative compensation acquired or originated at a premium or discount to the contractual per amount should be eligible to amortised cost.

For these reasons, we think that it is of the utmost importance that the second criterion of B4.1.12 A is removed. This would not endanger the entire SPPI concept and would not unduly extend the scope of eligible instruments. As an alternative, this second criteria should be reworded to refer only to the unlikeliness that prepayment will occur instead of referring to the fair value of the prepayment option. The aim would be the same, namely avoiding recognising at amortised cost instruments subject to frequent catch up adjustments, without introducing additional complexities, while more faithfully representing the economic reality of these transactions.

Finally, as highlighted by the French "Autorité des Normes Comptables", we are not convinced that differing the application date to 01/01/2019 would solve the issue of the application date of the amendment. We therefore insist on the necessity for the European Union and the different stakeholders to find a solution regarding the endorsement, to enable European entities to apply the amendment to be issued from the 01/01/2018.

Should you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely,

Lars Machenil