EFRAG
European Financial Reporting Advisory Group

Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9) Draft Comment Letter

Comments should be submitted by 17 May 2017 by using the '[Express your views](#)' page on EFRAG website or by clicking [here](#)

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

[Date]

Dear Mr Hoogervorst,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2017/3 *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9)*, issued by the IASB on 21 April 2017 (the 'Amendments').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG considers that financial instruments containing prepayment features with negative compensation could be eligible for measurement at amortised cost or at fair value through other comprehensive income ('FVOCI'). EFRAG is of the 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.

EFRAG considers that prepayment features with negative compensation should be subject to the same eligibility conditions as prepayment features with positive compensation. As a result, EFRAG agrees with the first eligibility criterion proposed in the Amendments but not with the second one. This second criterion states that the fair value of the prepayment feature should be insignificant at initial recognition. EFRAG notes that this criterion does not apply to prepayment features with positive compensation and is concerned that it would unduly restrictive. Moreover, given that the Amendments are being developed on a fast track timetable, EFRAG questions 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 are appropriate.

EFRAG notes that modifying IFRS 9 *Financial Instruments* a few months before its effective date will inevitably affect the implementation efforts already undertaken by many preparers (including early adopters) and by users. In order to minimise any disruption, EFRAG requests 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. Consequently, EFRAG is 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.

Further, EFRAG recommends that the IASB include an effective date of 1 January 2019, with early application permitted, rather than the date proposed in the Amendments. EFRAG notes that, in jurisdictions with a translation and/or endorsement process that cannot be completed by a due date of 1 January 2018, entities would have to classify and measure financial assets containing prepayment features with negative compensation at fair value through profit or loss when they first apply IFRS 9. Subsequently, they will have to change the classification and measurement of those financial assets to amortised cost or FVOCI for those financial assets to which the final amendments apply. EFRAG acknowledges such a situation is far from ideal and will require additional communication efforts from preparers, including the disclosures in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* relating to standards that have been issued but are not yet effective.

If a later effective date with early application is permitted, EFRAG sees no negative impact for entities in the EU if the Amendments can be endorsed before the end of the first quarter of 2018. In that case, entities will be in a position to apply the Amendments at the same time as IFRS 9.

If the proposed Amendments can be applied at the same time as IFRS 9, EFRAG agrees with applying them retrospectively. EFRAG sees no need for additional transition requirements beyond those proposed in the Exposure Draft if the effective date is deferred to 1 January 2019 with early application permitted.

EFRAG's detailed comments and responses to the questions in the Exposure Draft are set out in the Appendix.

If you would like to discuss our comments, please do not hesitate to contact Didier Andries, Joachim Jacobs, Ioanna Chatzieffraimidou or me.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix - EFRAG's responses to the questions in the Amendments

Question 1 – Addressing the concerns raised

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?

Notes to constituents - Summary of the proposals in the IASB Exposure Draft

1 *After IFRS 9 Financial Instruments was issued, the IFRS Interpretations Committee (the Interpretations Committee) received a submission questioning how to classify particular prepayable financial assets when applying IFRS 9. Specifically, the Interpretations Committee was asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding ('SPPI') if its contractual terms permit the borrower to prepay the instrument at a variable amount that could be more or less than unpaid amounts of principal and interest, such as the instrument's current fair value or an amount that reflects the instrument's remaining contractual cash flows discounted at the current market interest rate.*

2 *The prepayment features described in the submission to the Interpretations Committee could force the lender to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. That is, in effect, the prepayment includes an amount that reflects a payment to the borrower (i.e. negative compensation), instead of compensation from the borrower, even though the borrower chose to terminate the contract early.*

3 *Interpretations Committee members suggested that the IASB consider whether amortised cost measurement could provide useful information about particular financial assets with prepayment features that may result in negative compensation, and if so, whether the requirements in IFRS 9 should be changed in this respect. However, the Interpretations Committee acknowledged that amortised cost measurement would not be appropriate for all such prepayable financial assets and it could be difficult to define the relevant population. As a result of the Interpretations Committee's request, the IASB is proposing a narrow scope exception to IFRS 9.*

EFRAG's response

EFRAG welcomes 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.

4 EFRAG appreciates the IASB's initiative to address concerns raised during the implementation of IFRS 9 as, based on initial outreach, prepayment features with negative compensation exist in different types of loans in various jurisdictions across Europe. Our initial outreach also revealed that prepayment features with negative compensation do not necessarily arise from a legal or regulatory requirement. Further, prepayment features with negative compensation are generally not contingent on the occurrence of any specific 'trigger' event; although in some contracts they can only be exercised at specified dates.

5 EFRAG acknowledges that amending IFRS 9 so close to its effective date may create difficulties, in particular for jurisdictions with translation requirements and/or endorsement processes such as the European Union ('EU'). On balance, however, EFRAG is of the view that addressing the concerns related to prepayment features with negative compensation is worthwhile as it will clarify the accounting for financial instruments that incorporate prepayment features with negative compensation.

6 In order to minimise any disruption, EFRAG requests 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.

Question to Constituents

7 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.

Question 2 – The proposed exception

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?

Notes to constituents - Summary of the proposals in the IASB Exposure Draft

8 The exception to IFRS 9 that the IASB is proposing applies to particular prepayable financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 but do not meet that condition only as a result of the prepayment feature. The Amendments propose that financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are held, if the following two conditions are met:

(a) *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*

(b) *the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset.*

9 With regard to the first condition, the IASB recalls that amortised cost provides useful information about particular financial assets with simple cash flows that represent principal and interest. Amortised cost is calculated using the effective interest method, which is a relatively simple measurement technique that allocates interest over the relevant time periods using the effective interest rate. More complex cash flows require a valuation overlay to contractual cash flows (i.e. fair value) to ensure that the reported financial information is useful to users of financial statements.

10 The existing notion of reasonable additional compensation for early termination of a contract in IFRS 9 accommodates a prepayment amount that can be more or less than unpaid amounts of principal and interest, depending on which party chooses to terminate the contract early. Prepayment features that do not depend on which party chooses to prepay, but only on the movement in the relevant market interest rate, may result in negative compensation (i.e. a penalty) and are inconsistent with cash flows addressed in paragraph B4.1.11(b) of IFRS 9.

11 According to the IASB, financial assets that are prepayable at their fair value are inconsistent with measurement at amortised cost as such prepayment amounts may not only result in negative compensation but also because the amount exposes the holder to changes in the fair value of the instrument and contractual cash flows resulting from such exposure are not solely payments of principal and interest.

12 The second eligibility condition is proposed to ensure that the scope of the proposed exception is sufficiently narrow and that amortised cost measurement is not extended beyond the population of financial assets for which the effective interest method could provide useful information. To achieve that objective, the IASB proposes that the fair value of the prepayment feature should be insignificant when the entity initially recognises the financial asset. IFRS 9 does provide the possibility to account for a catch-up adjustment if an entity revises its estimates of contractual cash flows. The Amendments state that a prepayment feature that can be called upon by both borrower and lender raises the frequency in which prepayment cash flows can arise that are different to the cash flows accommodated by paragraph B4.1.11 (b) of IFRS 9. The potential occurrence of more frequent catch-up adjustments is not considered to be in line with a simple measurement technique that allocates interest using the effective interest rate over the relevant time period.

EFRAG's response

EFRAG supports the proposal that financial instruments containing prepayment features with negative compensation could be eligible for measurement at amortised cost or at FVOCI. EFRAG considers 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 agrees with the first eligibility criterion.

However, EFRAG disagrees with the second eligibility criterion. EFRAG is of the view that the eligibility criteria for prepayment features with negative compensation should be aligned with those for prepayment features with positive compensation.

In addition, EFRAG considers 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 Amendments.

13 Amortised cost is a relatively simple measurement technique and is only applied to financial assets with contractual cash flows that are SPPI and should be consistent with a basic lending arrangement.

14 EFRAG has considered the SPPI test and has concluded that its application under IFRS 9 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.

Assessing the first eligibility criterion

15 EFRAG understands that the proposed Amendments address those prepayment features that would meet the requirements in paragraph B4.1.11(b) of IFRS 9, except for the fact that they could result in compensation for the early termination of the contract that is negative. EFRAG understands that this condition would require the negative compensation to be 'reasonable', consistent with the requirement for positive compensation.

16 EFRAG considers the main issue to be the selection of the measurement basis that provides the most useful information to users of financial statements. EFRAG agrees that measurement at amortised cost can provide relevant information for financial instruments that contain prepayment features with negative compensation, if that negative compensation for early termination of the contract does not significantly affect the effective interest rate calculation at inception.

17 EFRAG notes the reference of the IASB in paragraph BC18 of the Basis for Conclusions of the proposed Amendments that financial assets that are prepayable at fair value do not qualify for an amortised cost measurement. The IASB asserts here that such a prepayment amount is inconsistent with paragraph B.4.1.11(b) of IFRS 9 because the amount exposes the holder to changes in the fair value of the instrument, and contractual cash flows resulting from such exposure are not SPPI. In other words, the IASB concludes that a fair value amount is not a reasonable compensation for the early termination of the contract.

18 Moreover, in paragraph BC18 of the proposed Amendments, the IASB concludes that amortised cost does not provide useful information for a financial asset that is

prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument *if* that prepayment amount is inconsistent with paragraph B.4.1.11(b) of IFRS 9, because the instrument exposes the holder to factors that could result in contractual cash flows that are not SPPI.

19 EFRAG is very concerned 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 Amendments are intended to address. These references seem to interpret existing guidance in IFRS 9, including the meaning of ‘reasonable compensation’ in the context of prepayment options with positive compensation features. EFRAG considers that interpreting ‘reasonable compensation’ so close to the effective date risks causing unnecessary disruption at this late stage in preparers’ implementation efforts. We therefore recommend removing this guidance from the final Basis for Conclusions.

Assessing the second eligibility criterion

20 The stated aim of the second eligibility criterion is to limit the scope of the proposed exception to instruments for which prepayment (and consequently negative compensation) is unlikely to occur. To achieve this, the prepayment feature will be eligible only if its fair value is insignificant at initial recognition.

21 EFRAG notes that, in accordance with paragraph B4.1.11(b) of IFRS 9, prepayment options for which the prepayment amount includes a compensation element are considered to result in contractual cash flows that are SPPI provided that compensation element is ‘reasonable’. Further, EFRAG recalls the guidance from IFRS 9 that all contingent features must be assessed in the same way. Consequently, we question why a prepayment feature with negative compensation is to be treated differently than one that provides reasonable additional (positive) compensation as permitted by paragraph B4.1.11(b) of IFRS 9.

22 EFRAG is 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 Amendments are being developed on a fast track timetable, EFRAG questions whether the IASB has or will be able to obtain sufficient evidence of the types of instrument that would be excluded by second criterion and whether those outcomes are appropriate.

23 EFRAG acknowledges that prepayable financial assets with positive compensation features that were acquired or originated at a premium or discount to the contractual par amount are subject an ‘insignificant fair value at initial recognition’ criterion (paragraph B4.1.12 of IFRS 9). However, this criterion has been justified as an exception to the general guidance based on the particular circumstances of this sub-category of prepayable financial assets. EFRAG considers that it is more appropriate that eligibility criteria for prepayable financial assets with negative compensation is aligned with the main guidance on prepayable assets in paragraph B4.1.11 (b) of IFRS 9 than with sub-category addressed by paragraph B4.1.12 of IFRS 9.

24 For these reasons, EFRAG disagrees with the second eligibility criterion.

Overall assessment

25 EFRAG expects that preparers have already analysed which of their financial instruments pass the SPPI test as the implementation date of IFRS 9 is very close. EFRAG assesses that the proposals in the Amendments should not be accompanied by references that could interpret existing guidance in IFRS 9, including the meaning of ‘reasonable compensation’. Any such reference might affect the accounting treatment of other instruments, which is beyond the scope of the Amendments.

26 EFRAG agrees with the first eligibility criterion, but not with the second one as EFRAG is of the view that the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation. If the IASB were to agree with this, EFRAG suggests the objective of the Amendments can be achieved more simply, by clarifying in paragraph B4.1.11(b) that the reasonable compensation for the early termination of the contract can both be positive or negative.

27 Finally, EFRAG is concerned about potential spill-over effects of the Amendments, i.e. whether the eligibility criteria of the Amendments could affect financial instruments other than the ones intended. EFRAG is asking its Constituents to provide evidence of this in responding to the Draft Comment Letter.

Questions to Constituents

28 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.

29 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.

Question 3 – Effective date

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?

Notes to constituents - Summary of the proposals in the IASB Exposure Draft

30 The IASB is proposing that an entity shall apply the Amendments for annual periods beginning on or after 1 January 2018 with earlier application permitted. If an entity applies those Amendments for an earlier period, it shall disclose that fact.

31 The IASB thinks there would be significant benefits if entities initially apply IFRS 9 taking into account the effect of the proposed exception. Specifically, the IASB thinks that it would be inefficient and burdensome for entities to initially apply IFRS 9 without this exception and then be required to change the classification and measurement of some prepayable financial assets when they apply the exception at a later date.

32 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.

EFRAG's response

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

33 EFRAG is concerned about the short time period between the expected date of issuing the proposed 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 EU, and it is highly unlikely that such processes can be finalised by 1 January 2018 in all jurisdictions. In particular, when first applying IFRS 9, entities will need to measure the financial instruments containing prepayment features with negative compensation at fair value through profit or loss. Subsequently, following the completion of the translation or endorsement process, 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 couple of months will raise questions from users of financial statements, and require specific communication efforts from preparers.

34 Therefore, EFRAG recommends that the IASB provide a later effective date of 1 January 2019, with early application permitted. This will allow jurisdictions with translation and/or endorsement processes to finalise such processes before the mandatory effective date of the Amendments. However, even if the effective date is deferred to 2019, entities in the EU that apply the Amendments at the due date would have to classify and measure financial assets containing such prepayment features 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 for those financial assets to which the final amendments apply. That is, they would be in the same position as entities that have already adopted IFRS 9 and who have not early adopted the Amendments.

35 EFRAG notes that early adoption will reduce the time between the effective date of IFRS 9 and the effective date of the Amendments. However, EFRAG notes that entities in jurisdictions that are subject to a translation or an endorsement process cannot apply the Amendments before it is endorsed.

36 EFRAG notes that if the Amendments have an effective date of 1 January 2019, with early application allowed, entities in the EU that file financial statements on a quarterly basis will not be negatively impacted if, and only if, the Amendments are endorsed before the end of the first quarter of 2018. That is because entities can early apply the Amendments at the same time as IFRS 9.

37 We address our comments on transition in question 4 below.

Question 4 - Transition

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?

Notes to constituents - Summary of the proposals in the IASB Exposure Draft

38 The IASB is proposing that, consistent with the existing requirements in IFRS 9, the Amendments would be applied retrospectively. Accordingly, an entity would need to determine whether a prepayable financial asset meets the conditions set out in paragraph B4.1.12A, on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, including whether the fair value of the prepayment feature was insignificant.

39 The IASB believes that entities will have the required fair value information because the information is required to apply the embedded derivative requirements in IAS 39. However, the IASB is acknowledging that it may be impracticable for an entity to determine whether the fair value of the prepayment feature was insignificant at the date of initial recognition if it had previously designated the financial asset under the fair value option applying IAS 39. Accordingly, the IASB proposes that if it is impracticable for an entity to make that determination on the basis of the facts and circumstances that existed at the initial recognition of the asset, then the entity must assess the contractual cash flow characteristics of the financial asset without taking into account the proposed exception set out in the Amendments. This proposal is similar to the existing transition provisions in IFRS 9 for assessing some other contractual features (see paragraphs 7.2.4 and 7.2.5 of IFRS 9).

40 The IASB is proposing that an additional disclosure requirement is added to IFRS 7 Financial Instruments: Disclosures for circumstances in which an entity applies the transition provision described above (and thus assesses the contractual cash flows without taking into account the proposed exception). In such circumstances, the entity would disclose the carrying amount of those financial assets until they are derecognised.

41 As noted above, the effective date of the proposed Amendments is the same as the effective date of IFRS 9 therefore the IASB believes that most entities would initially apply IFRS 9 taking into account the effect of the proposed exception. However, the IASB acknowledges that some entities have already early applied IFRS 9 and would therefore need to apply the exception retrospectively, subject to the requirements for changes in accounting policies in IAS 8. Therefore the transition provisions in IFRS 9 would not be applicable when the entity applies the Amendments.

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.

EFRAG sees no need for additional transition requirements in the case that the effective date would be 1 January 2019 with early application permitted.

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

43 If the IASB agrees with a later effective date of 1 January 2019 (with early application permitted), EFRAG sees no need for transition requirements beyond those proposed in the Amendments.

44 EFRAG acknowledges 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 notes 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 information required by paragraphs 30 – 31 of IAS 8 requires an entity to disclose the known or reasonably estimable information relevant to assessing the possible impact that the application of a new IFRS Standard will have on the entity's financial statements in the period of initial application. This disclosure should somewhat mitigate the potential communication issues.