

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

**Feedback to constituents – EFRAF Final Comment Letter**

**May 2017**

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## Introduction

### Objective of this feedback statement

The IASB published its Exposure Draft ED/2017/3 *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 ED 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 ED was 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 to IFRS 9 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 to IFRS 9.

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

### **Comments received from constituents**

EFRAG received and considered 15 comment letters from constituents. These comment letters are available on the EFRAG [website](#).

The comment letters came from national standard setters, preparers, preparer organisations, an audit firm and a regulator.

#### *Summary of respondents' comments*

##### *Question 1*

None of the respondents disagreed with the need to address the issue of prepayment features with negative compensation. Three respondents noted that the issue could be addressed by a clarification rather an Amendment to IFRS 9, while one respondent explicitly stated that the issue could not be addressed by a clarification. While not disagreeing with the IASB pursuing the Amendments to IFRS 9, one respondent suggested that the IASB should better articulate the reason it decided to pursue them at this point in time and explain why the proposed scope is appropriate.

Six respondents provided examples of the sectors and/or types of loans where such instruments are seen. One respondent noted that they were not aware that such instruments were widespread in their jurisdiction.

##### *Question 2*

Eleven respondents explicitly agreed with the first eligibility criterion.

Ten respondents explicitly agreed with EFRAG's proposal to remove the second eligibility criterion and four did not agree. One respondent did not explicitly agree or disagree but provided arguments to support both views.

Nine respondents also supported EFRAG's view that the final Amendments to IFRS 9 should not be accompanied by references that interpret existing IFRS 9.

Two respondents considered that (some of) the references in the Basis for Conclusions in the ED should be included in authoritative guidance in IFRS 9.

Another respondent suggested the ED be finalised in its current form.

*Question 3*

Nine respondents were of the view that the Amendments to IFRS 9 should be applied at the same time as IFRS 9, i.e. at 1 January 2018, while two respondents agreed with EFRAG's tentative position. Four 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, five respondents requested that the endorsement process is completed in a timely manner in order to avoid successive changes in measurement of financial assets with negative compensation.

*Question 4*

Two respondents asked the IASB to consider additional transitional reliefs, while another respondent suggested that the Amendments to IFRS 9 should be applied retrospectively and with prospective application in case of impracticability.

**EFRAG's final comment letter**

EFRAG issued its final comment letter on 31 May 2017.

EFRAG's positions in the final comment letter are the same as the draft version. One change compared to the draft comment letter is that the reasons for proposing an effective date at 1 January 2019 is explained in more detail. The added text explains how a later tentative date, with early application permitted, may assist European entities that are US SEC Registrants and are required to file financial

statements in accordance with IFRS as published by the IASB for US purposes.

## 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

### EFRAG's response to respondents' comments

#### Addressing the concerns raised

##### *Proposals in the ED*

After IFRS 9 was issued, the IFRS IC received a submission asking how to classify particular prepayable financial assets. 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 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 amortised cost measurement could provide useful information about specific financial assets with such prepayment features, and if so, whether the requirements in IFRS 9 should be changed in this respect.

In response to the IFRS IC recommendation, the IASB decided to propose a narrow-scope 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 assessment of the business model in which they are held, if particular conditions are met.

##### *EFRAG final position*

Based on the comments from respondents that generally supported EFRAG's tentative position, EFRAG maintained that position in its final comment letter.

In finalising the assessment, EFRAG considered the detailed examples provided by respondents.

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

*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 these financial instruments. 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 addressing the concerns relating to prepayment features with negative compensation. While not disagreeing with it, one respondent suggested that the IASB better explain the reasons for and scope of the Amendments to IFRS 9.

Three respondents suggested to address the issue by some form of clarification instead of an Amendment to IFRS 9. In contrast, one respondent was of the view that the objective of the Amendment to IFRS 9 could not be achieved through a clarification, as the option to measure financial instruments with a negative compensation feature at amortised cost or FVOCI is an exception to the SPPI criterion.

EFRAG asked constituents to provide examples about financial instruments with prepayment features with negative compensation.

Six respondents provided detailed information. They noted that such features occurred in the UK Social Housing Sector; the aircraft industry financing; asset based financings for large corporates; in loans to private mortgage borrowers which are allowed only to prepay if they sell their property; in certain large corporate bonds; and in retail mortgages and corporate loans in Switzerland.

**EFRAG's response to respondents' comments**

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

### 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. Such financial assets would be eligible to be measured at amortised cost or at FVOCI, subject to the assessment of the business model, when 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*

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.

## EFRAG's response to respondents' comments

#### *EFRAG final position*

Considering the support received from respondents, EFRAG maintained its initial position.

EFRAG acknowledged that some respondents disagreed with EFRAG's proposal to remove the second eligibility criterion. Based on feedback and examples from respondents, the second criterion could exclude some instruments from being measured at amortised cost or FVOCI, while similar financial instruments with positive compensation would be eligible for measurement at amortised cost or FVOCI.

As noted in its draft comment letter, 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.

Lastly, neither the ED nor comments from respondents provided any conceptual argument for introducing the second 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*

*First eligibility criterion*

Eleven respondents explicitly agreed with the first eligibility criterion. One respondent disagreed with 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 suggested 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.

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*Second eligibility criterion*

EFRAG asked constituents to provide evidence of financial instruments with prepayment features with negative compensation that would not pass the SPPI-test, in contrast to financial instruments with positive compensation. EFRAG also asked whether removing the second eligibility criterion would result in a more appropriate measurement of financial instruments with negative compensation.

Ten respondents agreed with EFRAG's tentative view and did not support the second eligibility criterion. Four respondents explicitly agreed with the second eligibility criterion. One respondent did not explicitly agree or disagree but provided arguments on both views.

Reasons provided for rejecting the second eligibility criterion were:

- prepayment features with negative compensation should be subject to the same eligibility criteria as prepayment features with positive compensation;
- the second criterion could limit the scope of the Amendments to IFRS 9 to such an extent that it minimises the benefit without a supporting conceptual basis;
- the introduction of the second eligibility criterion was lacking a conceptual justification;
- the difficulties in determining the fair value of a prepayment option for all loans that allow negative compensation would introduce undue complexity in applying IFRS 9; and
- the fair value of a prepayment option was not a good measure of the likelihood of it being exercised, as borrowers do not normally choose to prepay in order to make fair value gains, but for operational purposes or to manage their interest rate costs.

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

Two respondents indicated that the most frequent case of financial instruments that would fail SPPI because of the second eligibility criterion exists in fixed rate loans 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. The respondents noted that demonstrating whether the fair value of the prepayment feature is insignificant was challenging, if not impossible, even if in practice these options are rarely exercised.

Another example concerned prepayment by the borrower by discounting remaining cash flows using the new current benchmark rate with the initial credit spread. This instrument may not pass the second eligibility criterion, because the prepayment option has value for the borrower as it allows benefiting from better credit spread conditions.

One respondent who believed that the second eligibility criterion was appropriate did not agree with the views that including this second criterion is too restrictive, could have unintended consequences and create complex operational challenges and disruption. That respondent was concerned that suggesting the removal of the second eligibility criterion might result in the IASB replacing it with something more restrictive such as a consideration of the likelihood of exercise.

Two respondents noted that this criterion is needed as a safeguard in response to the increased potential variability of cash flows that is associated with the existence of such negative prepayment features which introduce a sort of economic leverage in the host instrument.

*Interpreting existing IFRS 9*

Nine respondents supported EFRAG's view that the final Amendments to IFRS 9 should not be accompanied by references that interpret existing

**EFRAG's response to respondents' comments**

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

IFRS 9, including the meaning of reasonable compensation (for example, paragraphs BC18, BC21-BC24) of the ED, while one stated that the ED should be finalised in its current form.

One respondent added that deletion of the draft guidance may not be enough, as it may have already created a precedent on how IFRS 9 is to be interpreted. The respondent suggested that the IASB should respond to the criticism, reconsider the usefulness of the guidance and delete the interpretative 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 of termination.

On the other hand, one respondent stated that the scope exclusion included in paragraph BC18 of the ED, where the prepayment amount is at fair value, should be part of the authoritative guidance in IFRS 9. Another respondent suggested the guidance in paragraphs BC21–BC24 to be included in the authoritative part of IFRS 9 when the Amendments are finalised.

**EFRAG's response to respondents' comments**

**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 the Amendments to IFRS 9 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 to IFRS 9 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

**EFRAG's response to respondents' comments**

*EFRAG final position*

Based on comment from respondents, EFRAG continued to recommend that the effective date be 1 January 2019 with early application permitted but explained in more detail the reasons suggesting that date. The added text explained how a later tentative date, with early application permitted, may assist European entities that are US SEC registrants and are required to file financial statements in accordance with IFRS as published by the IASB for US purposes.

EFRAG acknowledged the concerns raised by respondents about the endorsement process but there can be no guarantee of a timely endorsement for an Amendment that will be issued a few months before its effective date.

EFRAG retained its draft view on the proposed transitional provisions as they were supported by the majority of respondents. No major concerns were raised by the two respondents that proposed additional transition provisions.

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

endorsement processes to finalise such processes before the mandatory effective date, while the possibility to early apply the Amendments to IFRS 9 provides preparers with the ability to implement soon after finalisation of any translation or endorsement process.

*Transition*

Assuming that the proposed Amendments to IFRS 9 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 to IFRS 9 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 to IFRS 9 later than the effective date of IFRS 9, should entities be unable 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*

Nine respondents were of the view that the Amendments to IFRS 9 should be applied at the same time as IFRS 9, i.e. at 1 January 2018. Two respondents agreed with EFRAG that the IASB set the effective date at

**EFRAG's response to respondents' comments**

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

1 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.

One of the arguments provided by four respondents was 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. Five 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, while another respondent suggested that the Amendments to IFRS 9 should be applied retrospectively and in case of impracticability, prospectively.

**EFRAG's response to respondents' comments**

## Appendix 1: List of respondents

**Table 1: List of respondents**

<b>Name of constituent<sup>1</sup></b>	<b>Country</b>	<b>Type / Category</b>
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 Banking 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
ANC	France	Standard Setter
ASCG	Germany	Standard Setter
ESMA	Europe	Regulator
Association for Financial Markets in Europe ('AFME')	Europe	Preparer organisation
Mazars	France	Audit firm
Organismo Italiano di Contabilità ('OIC')	Italy	Standard Setter

<sup>1</sup> 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**

<b>Respondent by country:</b>		<b>Respondent by type:</b>	
Belgium	1	Standard Setters	5
UK	2	Preparers	2
Europe	4	Preparer organisations	6
France	3	Regulator	1
Portugal	1	Audit firm	1
Germany	2		
Switzerland	1		
Italy	1		
	<b>15</b>		<b>15</b>