

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.

Summary and analysis of the comment letters received on EFRAG's draft comment letter IASB ED/2017/3 IFRS 9 Amendments – Prepayment features with negative compensation

- 1 Based on the comments received, the EFRAG Secretariat has developed a proposed EFRAG final comment letter that is presented as agenda paper 01-05.

Structure of the paper

- 2 This comment letter analysis contains:
 - (a) Background;
 - (b) Summary of respondents;
 - (c) Summary of respondents' views;
 - (d) Main positions in EFRAG's proposed final comment letter;
 - (e) Appendix 1 - detailed analysis of responses to questions in EFRAG's draft comment letter, EFRAG Secretariat's recommendations and questions to EFRAG TEG; and
 - (f) Appendix 2 – list of respondents.

Background

- 3 In its draft comment letter, EFRAG welcomed the IASB addressing the concerns related to prepayment features with negative compensation. 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.
- 4 However, EFRAG was of the view that prepayment features with negative compensation should be subject to the same eligibility conditions as prepayment features with positive compensation.
- 5 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 was beyond the scope of the proposed Amendments.
- 6 Lastly, EFRAG recommended that the IASB include an effective date of 1 January 2019, with early application permitted.

Summary of respondents

- 7 At the time of writing, nine (9) comment letters have been received, two (2) were from national standard setters and seven (7) from preparers or preparer organisations. In addition, the EFRAG Secretariat has been advised that further four (4) letters will be received shortly. The letters are summarised below.

Summary of respondents' views

Addressing the issues raised

- 8 None of the respondents disagree that the IASB should address the issue of prepayment features with negative compensation.
- 9 Two respondents note that the issue could be addressed by a clarification instead an amendment to IFRS 9. One respondent disagrees with this.
- 10 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 respondent observed that the use of symmetric clauses is widespread enough to justify an amendment to IFRS 9.

The proposed exception

First eligibility criterion

- 11 Six respondents agree with the first eligibility criterion.

Second eligibility criterion

- 12 Seven respondents do not agree with the second eligibility criterion, i.e. agree with EFRAG's tentative view. Two respondents disagree with EFRAG's proposal to remove the second eligibility criterion.

References interpreting existing guidance in IFRS 9

- 13 Six respondents support EFRAG's view that the final amendments to IFRS 9 should not be accompanied by references that interpret existing IFRS 9, while one respondent states that the ED should be finalised in its current form.

Effective date

- 14 Four respondents are of the view that the Amendments should be applied at the same time as IFRS 9, i.e. at 1 January 2018.
- 15 One respondent agrees with EFRAG that the IASB set the effective date at 1 January 2019 with early application permitted.
- 16 Four respondents demand that the endorsement process is done fast enough in order to avoid successive changes in measurement of financial assets with negative compensation.

Transition

- 17 Two respondents ask the IASB to consider additional transitional reliefs.

Question to EFRAG TEG

- 18 Does EFRAG TEG agree with EFRAG Secretariat's recommendations in *Appendix 1: Analysis and Summary of Comments* received?

Appendix 1 - Detailed analysis of responses to questions in EFRAG's draft comment letter, EFRAG Secretariat recommendations and questions to EFRAG TEG

Question 1

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 ED are designed to address these concerns.

Do you agree that the IASB should seek to address these concerns? Why or why not?

EFRAG's tentative position

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.

Summary of respondents' comments

- 19 Six respondents agree with EFRAG's tentative position. One respondent considers that the advantages of having the possibility to measure the affected financial assets at amortised cost outweigh the disadvantages associated with a late amendment.
- 20 One respondent disagrees with EFRAG's view that the objective of the amendment could be achieved through a clarification instead of an amendment of IFRS 9, as 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 were of the view a clarification could be used instead of an amendment.
- 21 One respondent believes the amendment as issued by the IASB is of critical importance to them as it will impact a portfolio in excess of CHF 140 billion of loans that will fall within the scope of the amendment. That respondent notes that the amendment in its current form successfully achieves the limited exception the IASB had agreed to provide which will be in line with IFRS 9's effective date.
- 22 Three respondents do not specifically comment on this question.

Unrelated issue

- 23 One respondent also encourages EFRAG to remind the IASB of the need to address the issue on recycling equity instruments at FVOCI in IFRS 9 before the effective date of IFRS 17 as they believe that recycling should be allowed at latest at de-recognition date.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 24 Based on the comment letters received, the EFRAG Secretariat proposes not to change the answer to question 1.

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 make an Amendment to IFRS 9 so close to its effective date? Why or why not? Please explain and provide examples where possible.

Summary of respondents' comments

- 25 One respondent confirms that loans with prepayment features with negative compensation exist, for example in the UK Social Housing Sector. One respondent confirms that such loan features represent a significant part of specialised financing as the aircraft industry financing for instance. That respondent also confirms that these features are a common market practice for other asset-based financings of large corporates.
- 26 One respondent indicates that these features are generally restricted with private mortgage borrowers, which are allowed only to prepay if they sell their property. That respondent also confirms that their peers are not impacted to the same extent by the amendment as they are due to specific legal requirements such as the Swiss Unfair Competition Act.
- 27 One respondent states that the use of symmetric clauses is widespread enough and that the IASB should amend IFRS 9.
- 28 One respondent is not aware that such instruments are widespread in Portugal.
- 29 Four respondents do not specifically comment on this question.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 30 Based on the comment letters received, the EFRAG Secretariat proposes not to change the answer to question 1.

Question 2 – The proposed exception

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 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?

EFRAG's tentative position

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 assesses the negative sign of the reasonable compensation for early termination should not prevent measurement of a financial asset at amortised cost or FVOCI.

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.

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.

Summary of respondents' comments

First eligibility criterion

- 31 Six respondents agree with the first eligibility criterion.
- 32 The EFRAG Secretariat expects to receive the following comment from one respondent. That respondent disagrees 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. That respondent considers that it would be 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).
- 33 The same respondent finds it difficult in understanding why instruments that are prepayable at fair value should not be eligible for amortised cost measurement *because* they do not meet the SPPI condition while instruments with (symmetric) prepayment features that may lead to the party that chooses prepayment receiving compensation should be eligible for amortised cost measurement *although* they do not meet the SPPI condition.
- 34 Three respondents do not specifically comment on this eligibility criterion.

Second eligibility criterion

- 35 Seven respondents agree with EFRAG's tentative position, i.e. do not agree with the second eligibility criterion. Some of them note that prepayment features with negative compensation should be subject to the same eligibility criteria as prepayment features with positive compensation and it could seriously limit the scope of the financial instruments concerned. One respondent also notes the difficulties in applying the second eligibility criterion, for example in determining the fair value of a prepayment feature.
- 36 One respondent also notes 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. The respondent also observes 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.

- 37 The EFRAG Secretariat expects to receive the following comment from one respondent. That respondent recalls that the second eligibility criterion is not applicable to prepayment features with positive compensation. Having different eligibility criteria for prepayment features with positive and negative compensation may lead to uncertainty about the measurement of particular instruments as there is no priority set between eligibility criteria that apply for positive compensation features and eligibility criteria that apply for negative compensation features. This would affect situations such as:
- (a) Business combinations or acquisition of a portfolio;
 - (b) Financial instruments purchased on a secondary market; and
 - (c) Banking regulation that requires an entity to regularly sell and repurchase financial instruments for liquidity purposes.
- 38 One respondent does not support the second criterion for the reasons detailed below:
- (a) no instrument in practice would be eligible to this narrow scope amendment if prepayments at fair value would not meet the SPPI condition;
 - (b) the loans are clearly originated or purchased in a hold-to-collect business model without leverage and potential compensation only represents the present value of interest which consists of consideration for the time value of money, credit risk, other basic lending risks and costs as well as a margin;
 - (c) it is not clear why the conditions for the exceptions in paragraphs B4.1.12 and B4.1.12(A) should be mutually exclusive; and
 - (d) for asymmetric compensation there is no need to demonstrate that the fair value of the option is insignificant even if the credit spread of the borrower improved.
- 39 The same respondent suggests that, as an alternative, the second criterion should be reworded to refer only to the unlikelihood that prepayment will occur instead of referring fair value of the prepayment option. The respondent notes that 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.
- 40 Two respondents do not agree with EFRAG's position that the second eligibility criterion should be removed. In particular one respondent believes that the second eligibility criterion is appropriate and acceptable and aligns with the IASB's agreement to provide a limited exception. They do not believe any change is required at this late stage to the second criterion and do 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 paragraph B4.1.12 and is not something that should be debated at this late stage on a technical basis. The respondent is also not aware of any company that is materially impacted by the second criterion. They have already agreed a valuation technique with their auditors and have evidenced that this criterion would be satisfied for their portfolio of impacted loans. The respondent also notes 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.

References interpreting existing guidance in IFRS 9

- 41 Six respondents support 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.
- 42 One respondent adds 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.
- 43 One respondent states that the ED should be finalised in its current form.
- 44 Two respondents do not specifically comment on this question.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 45 Although there are a range of views relating to the two eligibility criteria, the majority agree with EFRAG's preliminary view. On that basis, the EFRAG Secretariat proposes not to change the answer to question 2.

Questions to Constituents

In applying the eligibility criteria, do you have evidence of financial assets with prepayment features with negative compensation that would not pass the SPPI test, while similar financial assets with prepayment features with positive compensation would pass the SPPI test? Please explain and provide examples where possible.

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.

Summary of respondents' comments

- 46 Two respondents are not aware of any specific examples where financial instruments would not qualify for the exception because they do not meet the second eligibility criterion. However, one of those respondents is of the view that the second eligibility criterion is needed to keep the Amendments applicable to a narrowly defined population of instruments and to prevent the inclusion of instruments with potential variability of cash flows due to such negative prepayment features.
- 47 One respondent indicates that the most frequent case 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 swap hedging in interest rate component of the loan. They acknowledge 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 believes 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.
- 48 One respondent agrees with EFRAG that removing the second eligibility criterion will result in a more appropriate measurement of financial assets with prepayment features with negative compensation. That 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. The respondent is of the view that such prepayment should meet the exception criterion since the amount paid by the borrower represents the time value of money (present value of the remaining cash flows).

- 49 Five respondents do not specifically comment on this question.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 50 Based on the comment letters received, and the examples in agenda paper 01-02, it appears that there may be cases where criterion 2 could restrict the measurement of certain financial assets at amortised cost or FVOCI. Based on the reasoning in the draft comment letter, the EFRAG Secretariat sees no reason to change the answer to question 2.

Question 3 – Effective date

For the reasons set out in paragraphs BC25-BC26, 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.

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?

EFRAG's tentative position

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.

Summary of respondents' comments

- 51 Four respondents are of the view that the Amendments should be applied at the same time as IFRS 9, i.e. at 1 January 2018.
- 52 One respondent agrees with EFRAG that the IASB set the effective date at 1 January 2019 with early application permitted.
- 53 One respondent notes that the European endorsement process needs to be accelerated.
- 54 Three respondents note that deferral of the application date to 1 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. One respondent reiterates the fact that the amendment should be finalised in its current form.
- 55 One respondent observes that an effective date of 1 January 2018 is likely to create issues for foreign filers. One respondent observes that there is no guarantee for a timely endorsement to have an effective date of 1 January 2018. That respondent is of the view that in order to avoid successive restatements the amendment needs to be endorsed before the end of the first quarter of 2018.
- 56 Four respondents do not specifically comment on this question.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 57 Based on the comment letters received, the EFRAG Secretariat proposes to change question 3 slightly. The added text would explain the situation for entities submitting IFRS financial statements in the US *and* the EU and how a later effective date, with earlier adoption permitted, can address such a situation.
- 58 The EFRAG Secretariat acknowledges the concerns raised by respondents about the endorsement process but there can be no guarantee of a timely endorsement of an amendment that will be issued a few months before its application date.

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?

EFRAG's tentative position

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 case the effective date would be 1 January 2019 with earlier application permitted.

Summary of respondents' comments

- 59 One respondent asks the IASB to consider the following transitional reliefs:
- (a) provide a transitional provision that permits the assessment as of the date of adoption of the amendment instead of at the date of inception;
 - (b) not require from the restatement of prior periods, when entities apply the amendment mid-year; and
 - (c) clarify the interaction between the existing guidance in IFRS 9 for early adopters and the transitional guidance for determining fair value for prepayment features with negative compensation.
- 60 One respondent recommends allowing entities to assess the financial instruments on the basis of information available at transition, similar to provisions in IFRS 9.
- 61 Seven respondents do not specifically comment on this question.
- 62 One respondent urges to have the endorsement no later than end of June 2018 in order for it to be applied when entities prepare their half-year financial statements.

EFRAG Secretariat's recommendations to EFRAG TEG on EFRAG's proposed final position

- 63 Based on the comment letters received, the EFRAG Secretariat proposes not to change the answer to question 4.

Appendix 2 – List of respondents

- 1 Below is a list of the respondents to EFRAG’s draft comment letter on IASB’s ED/2017/3 *Prepayment Features with Negative Compensation (Proposed Amendments to IFRS 9)*.

Name of respondent	Country	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

Prepayment features with negative compensation – comment letter analysis

- 2 Below is a summary of the number of respondents by country and by category of respondent.

Country	Number of respondents
Belgium	1
UK	2
Europe	2
France	1
Portugal	1
Germany	1
Switzerland	1
Total	9

Category of respondent	Number of respondents
Preparers and preparer organisations	7
Standard Setter	2
Total	9