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Submitted electronically via [go.ifrs.org/comment](http://go.ifrs.org/comment)

24 May 2017

Dear Sirs,

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the IASB's Exposure Draft ED/2017/3 – “Prepayment Features with Negative Compensation – Proposed amendments to IFRS 9” (the ‘Amendments’). AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

As a general comment, we consider that having a prepayment feature with negative compensation in the terms of a financial instrument should not, in itself, disqualify the instrument from being eligible for measurement at amortised cost or fair value through other comprehensive income (‘FVOCI’). We note that banks provide fixed rate loans in response to market demand for such loans, enabling clients to be protected against increases in interest rates. Prepayment features found in such contracts are therefore intended to provide protection for unexpected events and not as a way to introduce a leverage feature in the loans. Examples of markets and jurisdictions where the types of instruments described in the ED are pervasive include the Swiss retail mortgage market as well as certain corporate loans.

We would urge the IASB to finalise these amendments as soon as possible in advance of the proposed 1 January 2018 effective date, in particular given the time subsequently required to complete the EU endorsement process. The absence of a timely solution to the concerns which have prompted the proposed amendments is likely to lead to more uncertainty for both preparers and users (as noted in paragraph

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BC8 of the ED which states that “the proposed exception adds complexity to IFRS 9 and, given the impending effective date of IFRS 9, could disrupt some entities’ implementation activities”).

Please see below for our detailed answers to the questions in the ED:

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 Board should seek to address these concerns? Why or why not?*

We welcome the IASB’s initiative of addressing the concerns raised by prepayment features with negative compensation. Not only can contracts with these features be important in the context of the European financing market, but they also help in levelling the playing field between the two parties to the agreement.

We also note that the types of symmetric prepayment loans described in the ED are common in certain jurisdiction and markets across Europe. In Switzerland for example retail mortgages include symmetric early termination compensation provisions in order to comply with the requirements of the Swiss Law against Unfair Competition as revised in 2012, whilst most Swiss corporate loans include such early termination compensation provisions as a result of best market practice. These types of loans are therefore pervasive and seen as basic lending arrangements for which the current measurement basis (amortised cost) best captures the future expected cash flows. Similarly, we understand symmetric prepayment features to be common market practice in financing contracts for certain corporate sectors or for SMEs as well as for the public sector in some jurisdictions.

Furthermore, we note that the existence of a symmetric prepayment option in the terms of the contract is not intended to introduce leverage in the terms of the instrument. In practice, the prepayment option in such loans will rarely be exercised, as there would not typically be an economic incentive to exercise it (if, for example, interest rates increase and the borrower decides to early repay his loan, the borrower will indeed receive compensation from the lender, but any subsequent refinancing would also take place at the higher interest rate).

## 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 the condition only as a result of a prepayment feature. Specifically, the Exposure Draft proposes 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 mode in which it is held, if the following two conditions are met:*

- (a) The prepayment amount is inconsistent with paragraph B.4.1.11(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) 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?*

We welcome the ED's proposals allowing financial instruments containing negative compensation prepayment features to be measured at amortised cost or FVOCI.

We are however concerned with the Basis for Conclusions accompanying the amendments extending the scope of the IFRS 9 guidance beyond what was necessary to provide an answer to the narrow question which led to the IASB issuing the ED. While we reiterate our strong support for adopting a solution to the issues identified in the consultation on a timely basis, we would also request removing from the Basis for Conclusions those paragraphs which interpret terms such as "reasonable compensation" or describe concepts such as "significance" which are difficult to evaluate in practice.

### *The eligibility criteria*

We agree in principle with the first eligibility condition proposed in the ED. We understand this first eligibility criterion (that the instrument should qualify as SPPI regardless of whether the compensation element is positive or negative, as long as the party which terminates the contract may only receive *reasonable* compensation as a result) as being meant to ensure that only those basic lending instruments which would otherwise qualify for SPPI (and do not only because of the prepayment feature) are covered by the amendment.

We also understand that the objective of the second eligibility criterion is to limit the exception from the general requirements in IFRS 9 proposed in the ED to “those financial assets for which the effective interest method provides useful information”.

The analysis undertaken by a few of our members which would be most impacted by the proposed amendments suggests that the second eligibility criterion could be implemented in practice, and it is preferable to continuing with the *status quo*. Most other AFME members however are concerned with the wording in the second eligibility criterion introducing, without a technical justification for the changes, undue complexity in applying the standard (by referencing the *significance* of the prepayment feature). We would also emphasise that, while noting the below concerns expressed by members, we view reaching a timely solution to the issues identified in the ED as our main concern given the tight implementation timeline. An example of a financial instrument which could be affected by the second criterion is provided by a fixed rate loan with symmetric prepayment penalties where the prepayment amount is calculated as the residual principal at the time of the termination of the contract, plus a breakage cost which would be equal to the cost to unwind a ‘vanilla’ interest rate swap hedging the interest rate component of the loan. Such a loan could be seen (based on the wording in the ED), as not meeting the SPPI criteria by failing the second eligibility criterion. It would therefore be challenging for entities to prove that the fair value of the prepayment value should be seen as insignificant, even when these instruments have features of a basic lending relationship and the prepayment option might be (based on historical data) rarely exercised.

We are also concerned with the concepts introduced by certain paragraphs from the Basis for Conclusions accompanying the ED. We note, for example, that BC18 of the ED states that “the IASB is aware that some financial assets are prepayable at their current fair value and some interested parties have expressed the view that those prepayable financial assets should be eligible for amortised cost measurement. The IASB concluded that such a prepayment amount is inconsistent with paragraph B.4.1.11(b) not only because it may 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”. We believe that the wording in BC18 goes beyond the objective of the proposed amendment and introduces new guidance in assessing whether certain instruments meet the SPPI criteria more generally. In particular, BC18 seems to lead to a need for reinterpreting existing guidance with respect to the concept of

“reasonable compensation” and goes beyond the scope of the amendments and the original submission received by IFRIC.

We also note that BC24 states that “if a prepayment feature compensates the parties to the contract only for the changes in the relevant market interest rate (...) such a prepayment amount is different from a prepayment amount equal to the instrument’s current fair value because it reflects compensation for the change in only part of the interest rate (...) but not in other drivers of fair value. Consequently, such a prepayment feature could have a fair value that is more than insignificant unless it is unlikely that the prepayment will occur”. We are concerned with the wording in BC24 leading instruments to fail the SPPI conditions, where the prepayment consideration is based upon the fair value of a fully collateralised interest rate swap (and credit risk would therefore not be a significant factor in the swap’s value). Such arrangements would currently be measured in most cases at amortised cost or FVOCI. BC24 provides therefore another instance where the Basis for Conclusions seem to extend the scope of the proposed amendments beyond the initial issue submitted to IFRIC.

Furthermore, paragraph BC21 of the ED notes as one of the reasons for introducing the second criterion as “recognizing [that] frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the effective interest method”. We believe however that this requirement goes beyond the current requirements for asymmetric prepayment options which would not have to meet this criterion.

For the reasons described above we would therefore recommend that the IASB removes those paragraphs in the Basis for Conclusions which go beyond the scope of the limited amendments proposed in the ED. Should the IASB like to continue exploring these issues in the future, they should be submitted for further comments from stakeholders through the IASB’s outreach activities and constitute the basis of a separate project.

### 3. Effective date

*For the reasons set out in paragraphs BC25-26, the Exposure Draft proposes that the effective date of the exception would be the same as the effective 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?*

We support aligning the effective date of these amendments to the effective date of IFRS 9 more generally (1 January 2018) and support therefore the IASB's proposal on this issue. Any alternative to the current effective date proposed in the ED threatens to introduce additional significant complexity in providing users with relevant information at the time of the first application of IFRS 9. We would therefore also urge the IASB to take into consideration the need for the endorsement process in the EU to be completed ahead of the proposed effective date when setting the timetable for issuing the final version of the amendments.

#### 4. Transition

*For the reasons set out in paragraphs BC27-28, the Exposure Draft proposes that the exception would be applied retrospectively, subject to a specific transition provision if doing so is impracticable.*

*(a) Do you agree with this proposal? Why or why not? If not, what would you propose instead and why?*

*As described in paragraphs BC 30-31, the Exposure Draft does not propose any specific transition provisions for entities that apply IFRS 9 before they apply the exception.*

*(b) 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 Exposure Draft? If so, what are those considerations?*

We support the proposal in the ED regarding transition provisions and have no other comments or suggestions on this topic.

We would be pleased to discuss any of the comments above in greater detail if that would be helpful.

Yours sincerely,



**Richard Middleton**

Managing Director, Co-Head of Policy Division