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STAFF PAPER

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IASB Meeting

Project	**Prepayment Features with Negative Compensation**		
Paper topic	Summary of comment letters		
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Introduction

1. This Agenda Paper provides a summary of the feedback received in comment letters on the Exposure Draft (ED) *Prepayment Features with Negative Compensation (*Proposed amendments to IFRS 9) as well as the feedback received at the Accounting Standards Advisory Forum meeting in April 2017 on the same subject. This paper is provided for information only. No decisions are required from the Board.

2. The ED was published in April 2017 with a 30-day comment period, which ended on 24 May 2017. The Appendix provides statistical information about the 60 comment letters received (as at 6 June 2017) by respondent type and geographical region.

Proposals in the ED

3. The ED proposed a narrow exception to IFRS 9 *Financial Instruments* for particular prepayable 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 the prepayment feature. Specifically, such a financial asset would be eligible to be measured at amortised cost or at fair value through other comprehensive income (FVOCI) subject to the assessment of the business model in which they are held if the following two conditions are met:

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(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 (hereafter called the first eligibility condition); and

(b) when the entity initially recognises the financial asset, the fair value of the prepayment features is insignificant (hereafter called the second eligibility condition).

4. The ED proposed that the effective date of the amendments would be the same as IFRS 9; that is, annual periods beginning on or after 1 January 2018. In addition, the ED asked if a later effective date would be more appropriate (with early application permitted).

5. Finally, the ED proposed that the exception would be applied retrospectively subject to a specific transition provision, if doing so is impracticable. Applying that specific transition provision, when an entity first applies the amendments, if it is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) for an entity to assess the second eligibility condition on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, then the entity would assess the contractual cash flow characteristics on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the proposed exception. The ED proposed no other specific transition provisions but asked for feedback on whether there are any additional transition considerations specific to entities that would apply the amendments after they apply IFRS 9.

Executive summary of the comments

6. The Basis for Conclusions on the ED used the label 'negative compensation' to refer to the outcome in which the party that chooses to terminate the contract early (or otherwise causes the early termination to occur) *receives* an amount (rather than *pays* an amount) for doing so. We have used that label throughout this paper.

7. In summary, the feedback received from all respondent types is as follows:

(a) Most respondents supported the Board's efforts to address the concerns raised about the classification of particular financial assets with prepayment features that may result in negative compensation. They believe some such prepayable financial assets should be eligible to be measured at amortised cost or at fair value through other comprehensive income (FVOCI) if that prepayment feature is the only reason the asset does not meet the 'solely payments of principal and interest' (SPPI) condition. Specifically, they said that prepayable financial assets should be eligible to be so measured if they do not meet the SPPI condition only because the compensation amount is 'negative', rather than 'positive'. They agree that amortised cost measurement provides useful information for such assets. Many respondents highlighted the urgency of the issue and urged the Board to finalise the amendments as soon as possible.

(b) Most respondents agreed that the amendments should have a narrow scope but they had mixed view on the proposed eligibility conditions as described in bullets (c) and (d) below.

(c) **The first eligibility condition**: Nearly all respondents who answered this question agreed with the first eligibility condition. However, many of these respondents , expressed concern that the Basis for Conclusions on the ED seems to interpret or provide additional guidance on some of the existing requirements in IFRS 9; in particular, the meaning of 'reasonable compensation for the early termination of the contract'. While that notion is used in the first eligibility condition proposed in the ED (see paragraph 3(a) of this paper), it also already exists in paragraph B4.1.11(b) of IFRS 9. Respondents said the amendments should not contain such interpretative guidance because that guidance is unnecessary, is outside the scope of the amendments and could have unintended consequences on the accounting for other instruments that the ED was not intended to address.

(d) **The second eligibility condition:** Respondents had mixed views. While some respondents supported it, more than half of the respondents

disagreed with the second eligibility condition and recommended that it be deleted.

(e) Respondents had mixed views on the proposed effective date. Many respondents agree with the proposal. However, some respondents, particularly those in jurisdictions where translation and/or endorsement processes are required before an IFRS Standard can be applied, said that they would prefer a later effective date; specifically, annual periods beginning on or after 1 January 2019 with early application permitted.

(f) Most respondents supported the proposal to require retrospective application of the amendments with the specific provision proposed in the ED (see paragraph 5 of this paper). Some respondents who preferred that the effective date of the amendments is later than the effective date of IFRS 9 said that particular transition provisions in IFRS 9 should be made available again when the entity applies the amendments.

Question 1—Addressing the concerns raised

8. Nearly all respondents agreed that the Board should address the concerns raised about the classification of particular prepayable financial assets that may result in negative compensation. Specifically, they believe that negative reasonable compensation for the early termination of the contract should not in itself preclude amortised cost measurement. These respondents expressed the view that, as long as an entity holds these prepayable financial assets to collect their contractual cash flows, then amortised cost provides more useful information because expected credit loss and interest revenue (calculated using the effective interest method) amounts are more relevant than changes in fair value when assessing the performance (and future cash flows) of these assets.

9. Many respondents from Europe, Australia and North America stated that financial assets with prepayment features that may result in negative compensation are common within their jurisdictions. Respondents provided specific examples including aircraft financing loans in France, retail mortgages in Switzerland, non-retail loans in Australia, loans granted by credit unions in Canada, and loans

granted by banks in the UK. Large accounting firms with global presence also stated that these features are common in certain markets and jurisdictions. Some of these respondents stated that prepayment features with negative compensation are intended to provide protection for the parties to the loan contract against changes in interest rates in the event of prepayment and are not used as a way to allow speculation on interest rates or introduce leverage.

10. Many respondents from Asia, Africa and Latin America stated that prepayment features that may result in negative compensation are not common in their jurisdictions.

11. Most respondents urged that the amendments be finalised as soon as possible so that entities can apply IFRS 9 taking into account the effect of the amendments. Some added that timely finalisation is critical so that the amendments have a better chance to be endorsed and/or translated in respondents' jurisdictions before the effective date of IFRS 9.

12. Whilst agreeing that the Board should address the concerns about financial assets with prepayment features that may result in negative compensation, some respondents expressed the following views:

    (a) Many respondents believed that the proposals in the ED are not an 'exception' to the requirements in IFRS 9. In their view, negative compensation can still be consistent with the notion of a 'basic lending arrangement' and its the resulting cash flows can meet the SPPI condition as described in IFRS 9. See related comments in paragraph 23 below.

    (b) A few expressed concern that introducing an exception would be a rule-based solution and would increase complexity, which in turn would reduce the understandability of the requirements in IFRS 9.

    (c) Some said that the concerns about negative compensation could be addressed by issuing an Interpretation or a clarification of the existing requirements. While they acknowledged the views expressed by the Board and the IFRS Interpretations Committee on that matter, they think either an Interpretation or a clarification would be a more workable solution. A few added that those solutions could mitigate

some of the concerns around the proposal's effective date and the lead time necessary for endorsing and incorporating the amendments into the legal framework where necessary; and

13. A few respondents disagreed that the Board should address the concerns about negative compensation:

    (a) A few respondents said that they believe the amendments are unnecessary because, in their view, the notion of 'reasonable additional compensation for the early termination of the contract' in paragraph B4.1.11(b) IFRS 9 already accommodates negative compensation. Further, these respondents expressed the view that paragraph B4.1.11(b) provides examples of contractual features that meet the SPPI condition and therefore does not explicitly prohibit prepayment features with negative compensation from meeting that condition.

    (b) A couple of respondents (accounting bodies and standard setters) said that although they were not opposed to the proposals in the ED, the amendments should not be made at this stage because amending IFRS 9 so close to its effective date could disrupt implementation of the IFRS Standard. They added that the Board should review the issue as part of a more comprehensive review process, eg as part of the post-implementation review (PIR) of IFRS 9, and provide fundamental solutions rather than proposing an exception shortly before the effective date. There were some respondents who shared similar concerns over the timing of the proposed amendments. Although they did not object to the Board addressing the concerns, they urged that Board better articulate why the amendments are necessary.

    (c) One respondent (a standard-setter) expressed the view that measuring a financial asset with a prepayment feature that may result in negative compensation at fair value through profit or loss provides more useful information because, for example, the holder is exposed to the risk of collecting an amount that is less than unpaid principal (for reasons other than credit)

14. A couple respondents said that the 30-day comment period was not sufficient to conduct an in-depth examination of the proposals in the ED and their ramifications. One respondent (an academic) disagreed with the rationale provided to reduce the comment period to 30 days.

Question 2—Eligibility conditions

15. Many respondents supported *both* proposed eligibility conditions. Consistent with the Board's views set out in the Basis for Conclusions on the ED, these respondents think the proposed conditions would improve the accounting for financial assets with particular prepayment features, without expanding the scope of the exception beyond the population of assets for which the effective interest method provides useful information. Other respondents generally supported the first eligibility condition but disagreed with the second eligibility condition. Feedback on those two eligibility conditions is summarised below.

First eligibility condition—reasonable negative compensation for the early termination of the contract

16. Nearly all respondents who answered this question agreed with the first eligibility condition. Most of them stated that they believe that the fact that the reasonable compensation for early termination of the contract could be negative (rather than positive) should not be the only reason that an entity is prohibited from measuring a financial asset at amortised cost or at FVOCI. Accordingly, they agree that the first eligibility condition captures the correct population of financial assets.

17. However, many respondents (including most of those respondents who said such features were common in their jurisdictions/market) were concerned that the Basis for Conclusions on the ED interprets or provides additional guidance on the existing requirements of IFRS 9, specifically, the meaning of 'reasonable additional compensation for the early termination of the contract'. These respondents pointed out that while that notion is used in the first eligibility condition, it also already exists in paragraph B4.1.11(b) of IFRS 9. Respondents said the amendments should not contain any such interpretative guidance because in their view:

(a) such guidance is unnecessary to achieve the objective and is outside the scope of the amendments, and could have unintended consequences on the accounting for other instruments that the ED was not intended to address ;

(b) entities implementing IFRS 9 have already exercised their judgement to apply the notion of 'reasonable additional compensation for the early termination of the contract' based on the existing principles in IFRS 9. Providing additional guidance that may change that application at this late stage could disrupt entities' implementation of IFRS 9; and

(c) it is inappropriate to provide guidance on such an issue in the Basis for Conclusions. Such guidance, if provided, should be included in the authoritative text of IFRS 9 after being subject to separate due process steps specific to that matter.

18. Specifically, these concerns were raised in the context of the discussion in the Basis for Conclusions about the classification of instruments that are prepayable at their current fair value and instruments that are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument. Paragraph BC18 says that the IASB concluded that a financial asset prepayable at its current fair value would not meet the first eligibility condition. That is because such a prepayment amount is inconsistent with paragraph B4.1.11(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. Therefore such a financial asset would be measured at fair value through profit or loss. Paragraph BC18 also says that the same conclusion would apply to 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 B4.1.11(b) because the amount exposes the holder to factors that could result in contractual cash flows that are not solely payments of principal and interest.

19. In addition to the concerns about providing interpretational guidance in the Basis for Conclusions (described in paragraph 17 of this paper), respondents disagreed

with those statements because they believe that such prepayment amounts could represent reasonable additional compensation for the early termination of the contract, and therefore could meet the SPPI condition, in some circumstances, for example, if the change in fair value only arises from changes in market interest rates because there have been no significant changes in credit spread. Therefore they believe that it is inappropriate to conclude that such prepayments amounts would *never* meet the SPPI condition.

20. On the other hand, a couple respondents (regulators or standard-setters) supported the additional explanation in the Basis for Conclusions on the ED about the notion of reasonable compensation for the early termination of the contract, including the statements discussed in paragraph 18 above. However, these respondents believe that the explanation should be relocated to the standard rather than in the Basis for Conclusions.

Second eligibility condition—the fair value of the prepayment feature at initial recognition

21. Respondents expressed mixed views about the second eligibility condition.

22. Respondents who agreed with the second eligibility condition generally supported it for the reasons that the Board set out in the Basis for Conclusions. However, more than half of respondents who answered this question, including most respondents who said that prepayment features with negative compensation are common in their jurisdiction or market, disagreed with the second eligibility condition. Paragraphs 23—29 below summarises the reasons respondents provided for their disagreement.

23. Most of the respondents who disagreed with the second condition said that the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation. Therefore, they expressed the view that the first eligibility condition is sufficient and the second condition should be deleted because it creates asymmetry; ie IFRS 9 does not require entities to assess the fair value of prepayment features with *positive* compensation. Similar to the feedback described in paragraphs 12(a) and 13(a) of this paper, these respondents think there is no compelling reason that prepayment features with negative compensation cannot meet the SPPI condition while

prepayment features with positive compensation can . In their view, the 'sign' of the compensation amount does not change the characteristics of the contractual cash flows such that fair value through profit or loss becomes a more relevant measurement.

24. Some respondents disagreed with the statements in the Basis for Conclusions on the ED that note the Board's view that it would be inappropriate if the proposed exception significantly increased the frequency of catch-up adjustments applying paragraph B5.4.6 of IFRS 9. In paragraph BC21, the Board notes that prepayable financial assets that meet the first eligibility condition change the circumstances, or more specifically they increase the frequency, in which contractual compensation amounts could arise and recognising such frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the objective of the effective interest method. However, respondents express the view that such catch-up adjustments are an inherent feature of the amortised cost measurement method and they note such adjustments are already required for prepayment features with positive compensation. They observed that when applying IFRS 9, the frequency of the catch-up adjustments in accordance with paragraph B5.4.6 does not determine whether or not a financial asset meets the SPPI condition. Although many of these respondents agreed that the need for catch-up adjustments may increase when a prepayment feature involves both negative and positive compensation, they did not agree that this fact justifies the second eligibility condition; ie they disagreed that such an increase in catch-up adjustments should have the result that prepayment features with negative compensation are treated differently (with more restriction) than prepayment features with positive compensation.

25. Some respondents expressed the view that the second condition unduly restricts the scope of the amendments. A few said that it may be challenging to demonstrate that the fair value of prepayment feature is insignificant at initial recognition unless an instrument is prepayable at fair value, which the Board noted would not meet the first eligibility condition. Some said that if the prepayment amount includes compensation only for movements in the benchmark interest rate (ie it excludes compensation for changes in credit risk of the borrower), then such prepayment features likely will have a fair value that is more

than insignificant, even if the probability of exercise is low. Others noted that the fair value of a prepayment feature would be more than insignificant if the asset is acquired in the secondary market or in a business combination and market interest rates have moved since the asset was originated.

26. Some respondents expressed the view that the second eligibility condition would not achieve the Board's stated objective; ie to restrict the scope of the amendments so that financial assets are eligible to be measured at amortised cost only if it unlikely that prepayment (and thus negative compensation)will occur.

    (a) Based on respondents' experience, the exercise of such features are often a business decision rather than a decision triggered by economic incentives such as fair value gains. Because of this, they think fair value is not a good measure of the likelihood that prepayment will occur.

    (b) The fair value of the prepayment feature will also reflect the probability that positive compensation will occur. In some circumstance, the fair value of the prepayment feature may be more than insignificant largely due to the fair value of positive compensation. See paragraph 27(a) below for more discussion on this point.

    (c) The fair value of the prepayment feature could still be insignificant even if it is likely that the feature will be exercised if:

        (i) the prepayment amount is close to fair value; and/or

        (ii) the estimated effect of positive compensation offsets that of negative compensation (if the compensation is symmetric).

27. There were mixed views on the difficulty of assessing whether the fair value of prepayment feature is insignificant when the entity initially recognised the financial asset:

    (a) Some observed that determining the fair value of the prepayment features would be difficult. A few noted that the added cost and complexity of applying the condition would outweigh any benefit that it provides. A few of these respondents said that if a prepayment feature may result in either positive compensation or negative compensation, the fair value of the prepayment features will reflect both outcomes. They expressed the view that this could be distortive because IFRS 9

does not otherwise require entities to assess the fair value of prepayment features with *positive* compensation. At least one respondent said that it is unclear how the second eligibility would be applied if the prepayment feature could result in negative compensation but the fair value of the feature, which is more than insignificant, reflects the fact that the holder expects to receive compensation rather than pay it; and

(b) A few preparers said that, although they think the second eligibility condition is unnecessary, it can be operationalised. Moreover, these respondents said that they could support the second eligibility condition if it is necessary for a timely finalisation of the amendments.

28. A few said that the first eligibility condition limits the scope of the exception to a sufficiently narrow population. They think the second condition has little added benefit in this regard and is therefore unnecessary.

29. A few respondents who did not support the second eligibility condition suggested alternatives if the Board decides to retain two eligibility conditions. These respondents said that the Board's objective of limiting the scope of the amendments could be better achieved by focusing on one of the following features:

(a) the probability of negative compensation, and thus catch-up adjustments, occurring (based on historical experience and expected behaviour of the prepayment option holder(s));

(b) the probability of prepayment occurring (based on historical experience and expected behaviour of the prepayment option holder(s)); or

(c) the intrinsic value of the prepayment feature (ie excluding time value of the feature).

Interaction between the existing exception in paragraph B4.1.12 and the proposed exception

30. Many respondents expressed concern about the explanation in the Basis for Conclusions on the ED about the interaction between the existing exception in paragraph B4.1.12 of IFRS (the exception that is applicable to assets that are

acquired at a premium or discount but are prepayable at the contractual par amount) and the exception proposed in the ED. Paragraph BC19 in Basis for Conclusions on the ED observes that those two exceptions are mutually exclusive because a financial instrument cannot meet the conditions (as drafted in IFRS 9 and the ED, respectively) for both exceptions. However, respondents said it is unclear why those exceptions should be mutually exclusive and expressed the view that the proposed exception should apply equally to financial assets that are originated and acquired (eg in a business combination).

Question 3—Effective date

31. Respondents had mixed views about the proposed effective date. More than half of the respondents agreed that the effective date of the amendments should be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018. These respondents generally agreed with the Board's rationale set out in the Basis for Conclusions on the ED. Others said they would prefer a later effective date; specifically, annual periods beginning on or after 1 January 2019 (with early application permitted) because this would allow jurisdictions with translations and/or endorsement processes to finalise such activities before the mandatory effective date. Some respondents noted that such a later effective date would ease the burden for those entities that otherwise would need to prepare their financial statements using IFRS Standards as issued by the Board and IFRS Standards as endorsed by their jurisdictional authority.

32. A few respondents from jurisdictions with endorsement processes noted that having a later effective date would still have the result that an entity would need to change the classification of particular financial assets. That is, financial assets with prepayment features that may result in negative compensation would be classified at fair value through profit or loss when an entity initially applies IFRS 9 and then may be classified at amortised cost or at FVOCI when the entity subsequently applies the amendments. For this reason, some of these respondents supported the proposed effective date even though there is a risk that the amendments would not be endorsed by then. They stressed that it is of utmost importance that the amendments are finalised as soon as possible.

Question 4—Transition

Retrospective application and transition provision

33. Nearly all respondents who answered this question agreed with retrospective application of the amendments and most agreed with the specific transition provision proposed in the ED (described in paragraph 5 of this paper). However, most of those respondents who did not support the second eligibility condition noted that the specific transition provision would be unnecessary if that condition were removed.

34. A few respondents said it could be challenging in some cases to determine the fair value of the prepayment features on the basis of the facts and circumstances that existed at the initial recognition of the financial asset. In those cases, they said that the assessment should instead be performed on the basis of the facts and circumstance that exist at the date of initial application of the amendments.

Transition provisions for those entities that apply IFRS 9 before they apply the amendments

35. Some respondents who supported an effective date later than annual periods beginning on or after 1 January 2018 said that any relevant transition provisions in Section 7.2 of IFRS 9 should be available again when the amendments are first applied. Some respondents specifically mentioned the provisions related to the fair value option, applying the effective interest method and impairment, as well as the relief from restating prior periods.

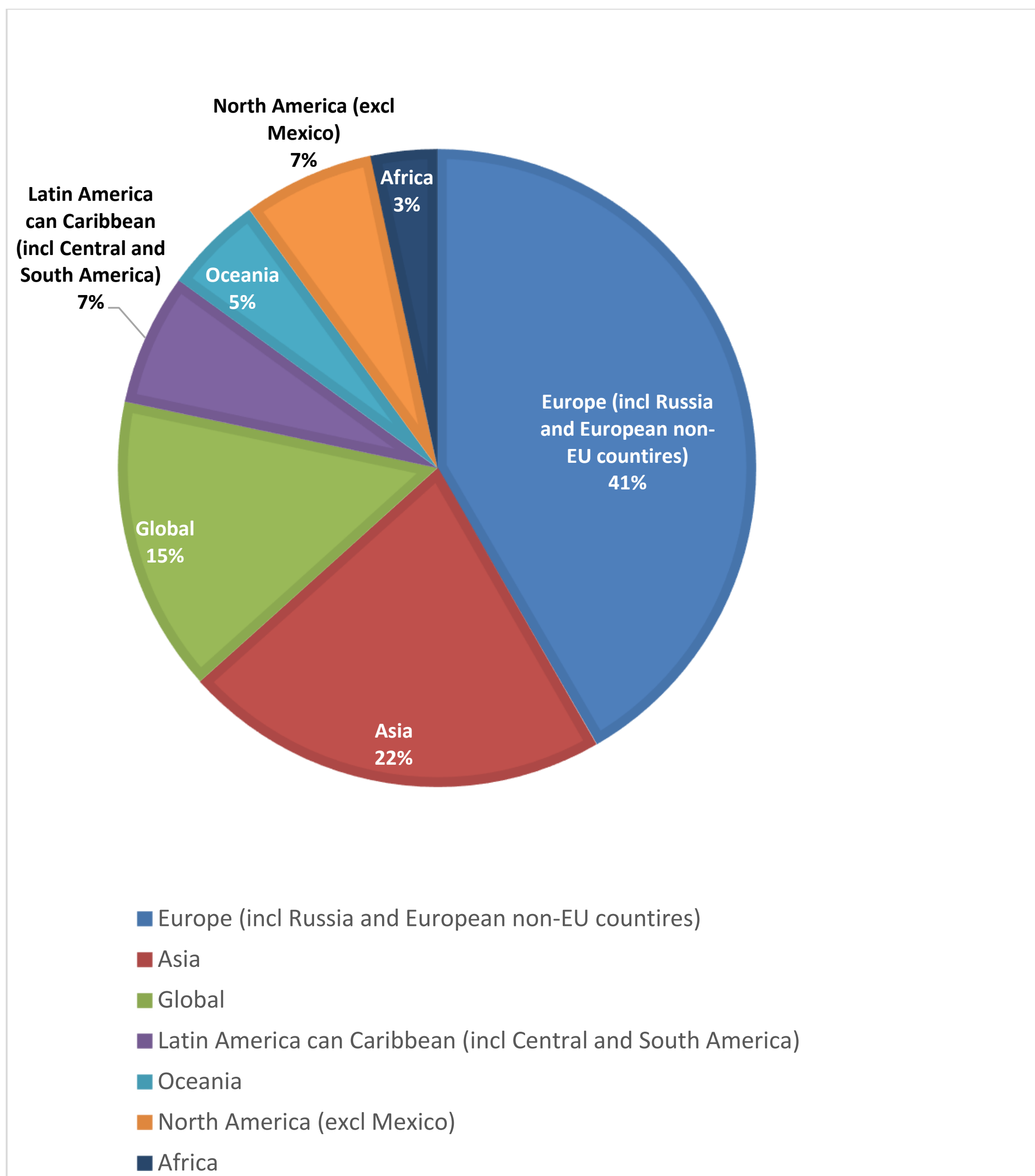
Question for the Board
Do the Board members have any questions on the summary of feedback received?

Appendix: Information on the comment letters

Comment letters

A1. As at 6 June 2017, we had received 60 comment letters, analysed by geographical region and type of respondents as follows:

Comment letter respondents by geographical location



Comment letter respondents by type