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Mr Hans Hoogervorst
International Accounting Standards Board
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Our ref MV/288

23 May 2017

Dear Mr Hoogervorst

Comment letter on ED/2017/3 *Prepayment Features with Negative Compensation*

We appreciate the opportunity to comment on the International Accounting Standards Board's Exposure Draft (ED) *Prepayment Features with Negative Compensation – Proposed amendments to IFRS 9*. We have consulted with, and this letter represents the views of, the KPMG network.

We support the Board's proposal to allow particular financial assets containing prepayment features which could result in negative compensation to be eligible for measurement at amortised cost or at fair value through other comprehensive income (FVOCI). However, we do not support including the second eligibility criterion in IFRS 9.B4.1.12A(b). Furthermore, we believe that the Board's comments in the Basis of Conclusions that appear to interpret what is seen as 'reasonable … compensation' under IFRS 9.B4.1.11(b) go beyond the scope of the amendment and should be deleted.

We appreciate the Board's speedy approach to addressing this matter and its acknowledgement of the benefits to entities of finalising the amendments before the effective date of IFRS 9.

The Appendix to this letter contains our responses to the specific questions raised in the ED and some additional comments on matters addressed in the ED.

Please contact Mark Vaessen +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix: Responses to specific questions
Question 1—Addressing the concerns raised

Paragraphs BC3–BC6 describe the concerns raised about the classification of financial assets with particular prepayment features applying IFRS 9. The proposals in this Exposure Draft are designed to address these concerns.

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

We agree that the Board should seek to address these concerns because these particular prepayment features are common in practice and we believe that amortised cost or fair value through other comprehensive income measurement (depending on the business model) will provide the most useful information about these assets.

Question 2—The proposed exception

The Exposure Draft proposes a narrow exception to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of a prepayment feature. Specifically, the 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 model in which it is held, if the following two conditions are met:

(a) the prepayment amount is inconsistent with paragraph B4.1.11(b) of IFRS 9 only because the party that chooses to terminate the contract early (or otherwise causes the early termination to occur) may receive reasonable additional compensation for doing so; and

(b) 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 agree with the first eligibility condition in (a) above. We believe that financial assets that otherwise meet the SPPI criterion except for the fact that they could result in negative compensation upon early termination can be seen as basic lending arrangements and that these features change only the frequency with which compensation is paid and the direction in which it is paid.

However, we note that the use of the words: “the party that chooses to terminate the contract early (or otherwise causes the early termination to occur)” does not seem to consider the case where the triggering event is one that is not caused by either party, e.g. it is triggered by an external event such as a change in law or regulation, and prepayment is mandatory if that event occurs. If the prepayment amount could result in negative compensation to either the borrower or lender, then in that case the asset would appear to fail the SPPI criterion since it would not be covered by the amendment. We believe those cases are similar and should not be treated differently to the ones envisaged by the narrow-scope amendment.

In addition, we do not believe the second eligibility condition in (b) above is necessary and suggest that it be deleted. Assessing the likelihood of exercise or the fair value of the prepayment feature on initial recognition would involve additional cost for preparers but does not appear to provide any corresponding benefit.

BC21 expresses the Board’s concern that these prepayment features increase the likelihood of IFRS 9.B5.4.6 ‘catch-up adjustments’ being made. However these adjustments are also applicable to prepayment features which only result in positive compensation. For those features, changes in the amount or timing of the cash flows result in ‘catch-up adjustments’ but IFRS 9 contains no requirement that the feature have an insignificant fair value at initial recognition.

Furthermore, we note that the amendment may address cases where the lender obtains a right to early termination when there is an event of default or a contingent event occurs. In such cases, it may be reasonable for the lender to receive compensation even though they have chosen to exercise their right to terminate and the other party has not caused the early termination (e.g. there is a material adverse change in economic circumstances). These cases would therefore meet the first eligibility condition. However, the second eligibility condition would not make sense in these cases as it does not seem reasonable to require the fair value of the prepayment feature to be insignificant on initial recognition – indeed, it seems counterintuitive that a feature which protects the lender should qualify only if the protection has little value or it is unlikely for such a default or similar event to occur.

We also note that, if the Board’s objective is to screen out options where the likelihood of exercise is low, there is a risk that the fair value-based approach proposed in the ED could lead to outcomes inconsistent with that objective.. In particular, it is possible that a prepayment feature might still have an insignificant fair value even though the probability of exercise is relatively high. This is because the prepayment feature may be symmetric (i.e. could give rise to positive or negative compensation), the expected prepayment amount might be close to fair value and the feature might be exercised for a wide variety of reasons (e.g. depending on a corporate borrower’s business needs or a retail customer’s personal circumstances and preferences), or be contingent on an event that is outside either party’s control.

Question 3—Effective date

For the reasons set out in paragraphs BC25–BC26, the Exposure Draft proposes that the effective date of the exception would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018 with early application permitted.

Do you agree with this proposal? Why or why not? If you do not agree with the proposed effective date, what date would you propose instead and why? In particular, do you think a later effective date is more appropriate (with early application permitted) and, if so, why?

We appreciate the Board's speedy response in trying to finalise the amendments before the effective date of IFRS 9. We believe it would be ideal if all entities implemented the amendment from 1 January 2018 and expect that preparers will wish to implement it from this date if possible.

However, many jurisdictions have endorsement processes that must be completed before entities can apply amendments to IFRSs in their statutory financial statements. Entities in those jurisdictions may not be able to prepare a single set of financial statements for their 2018 financial year that are compliant with both IFRSs as issued by the IASB and the currently-endorsed jurisdictional version of IFRS if it is not possible to endorse the amendment by 1 January 2018. This could be a particular problem for some entities – e.g. foreign private issuers registered with the SEC.

In light of this we propose that the amendments become mandatorily effective for annual periods beginning on or after 1 January 2019 with early adoption permitted. Having an effective date of 1 January 2019 with early adoption permitted would give jurisdictions time to finalise any endorsement processes while entities in jurisdictions without endorsement processes would be allowed to early adopt the amendment in their 2018 IFRS financial statements. Under this approach if an entity did not early adopt the amendment, it would still need to disclose the expected impact of the amendment on their financial statements to comply with the requirements of IAS 8, thus reducing concerns about lack of comparability.

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.

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

We support retrospective application in line with the general transition requirements of IFRS 9 (i.e. IFRS 9 is applied retrospectively subject to certain exceptions). As mentioned above, we believe that the second eligibility condition in B4.1.12A(b) is not necessary and should be removed. If the second eligibility condition is removed, it would also eliminate the need for the specific transition provision to be applied when retrospective application is impracticable.

If the amendment is finalised with this second eligibility condition, then we support the proposed transitional provision if it is impracticable for an entity to determine whether the fair value of the prepayment feature was insignificant at the date of initial recognition.

However, we recommend a minor clarification to the wording in the last sentence of proposed paragraph 42T of IFRS 7 to explain that the new disclosure requirement should only apply if B4.1.12A is relevant and not taken into account as opposed to all cases in which it is not taken into account.

As described in paragraphs BC30–BC31, 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?

For entities that apply IFRS 9 and its transitional provisions before they apply the amendment set out in this ED, BC31 points out that section 7.2 of IFRS 9 would not be applicable when the entity applies the amendment because an entity applies each of the transition requirements in IFRS 9 only once.

We agree that those entities would already have transitioned to IFRS 9. We believe however that such entities should also be allowed to apply a similar transition provision to IFRS 9.7.2.11 if it is impracticable to apply retrospectively the effective interest method, e.g. to treat the fair value of the financial asset at the date the amendment becomes effective as the new gross carrying amount at that date and to present the fair value at the end of each comparative period presented as the gross carrying amount of the financial asset.

Additional comments

Reasonable [additional] compensation

The guidance in BC18 states that financial assets prepayable at their current fair value are "…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." BC23 concludes that "that financial asset would be measured at fair value through profit or loss." BC18 also states that the "same conclusion would also 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."

We believe the proposed limited-scope amendment to IFRS 9 should only address 'negative compensation' and not deal with what is 'reasonable [additional] compensation'. IFRS 9 conversion projects are already underway and the amendment could have unintended consequences for stakeholders that have likely already developed views as to what is 'reasonable'. If the Board intends to deal with what is 'reasonable' this would require a more extensive project and greater discussion, which is not feasible if the amendment is to be finalised before the end of the year. We therefore suggest deleting any wording in the Basis of Conclusions that could be seen to interpret what is 'reasonable [additional] compensation'.

In addition we disagree with the logic applied in these paragraphs. We understand that prepayment at current fair value is a type of make-whole provision and that this fair value is not driven by anything other than basic lending arrangement factors if the other cash flows are SPPI compliant. Rather this feature allows the borrower to prepay the instrument at an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate (inclusive of spreads for risks such as credit). If the market rate of interest is based on the full market rate, then this would be consistent with the discussion in BC14 that the compensation relates to 'lost interest revenue'. Using a full market rate arguably better reflects the value of that lost revenue. We would also note that the contractual interest rate on interest-bearing financial assets typically includes spreads for risks such as credit. Consequently, we believe that these features do not introduce any contractual cash flow amounts that are different from the cash flow amounts that are accommodated by paragraph B4.1.11(b) of IFRS 9.

In addition, we believe that compensation for breakage costs could be reasonable and acceptable if the hedge breakage is a valid cost incurred by the lender that is directly associated with the borrower's prepayment.

We are not asking the Board to provide more guidance on what is 'reasonable'. However we wish to highlight the following inconsistencies:

— In BC14, the Board describes two instruments for which it that it believes the effective interest method and thus amortised cost measurement could be appropriate – Asset A and Asset B. In both cases, compensation is based on "the relevant market interest rate." However it is not clear in these examples whether the market interest rate is a benchmark rate or an interest rate that includes spreads for risks such as credit. BC14 implies that the market interest rate would include all relevant spreads because it describes the compensation as relating to “the present value of lost interest revenue” over the asset’s remaining term. However, BC24 states that the prepayment amount “reflects compensation for the change in only part of the interest rate (e.g. for a change in the benchmark rate)”.

— In January 2016[1], the IFRS Interpretations Committee described the term ‘market rate of interest’ as being linked to the concept of fair value in IFRS 13 Fair Value Measurement and including current market spreads. This description of a market rate of interest conflicts with the guidance in BC24.

There may be valid commercial reasons why a lender would not be willing to agree to a clause that could cause it to accept a loss on prepayment based on a deterioration in the borrower’s creditworthiness – however, that is not the issue at hand. Also, it is possible that the discount rate specified in the contract to calculate a prepayment amount might specify a credit or other spread based on market yields for instruments with a specified credit rating (e.g. the borrower’s rating at origination of the instrument) – such a rate would not reflect a full fair value measurement of the instrument but it would reflect changes in credit spreads and not just changes in a benchmark rate.

[1] IFRIC Update – January 2016: IAS 39 Financial Instruments: Recognition and Measurement – Separation of an embedded floor from a floating rate host contract in a negative interest rate environment.