**David Schraa**
*Regulatory Counsel*

May 24, 2017

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
EC4M 6XH London
United Kingdom

**Re: Comments on Exposure Draft ED/2017/3 - Exposure Draft on Prepayment Features with Negative Compensation - Proposed amendments to IFRS 9 (2017)**

Dear Mr. Hoogervorst:

1. The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), welcomes the opportunity to provide comments to the International Accounting Standard Board's (the "IASB" or Board) exposure draft.

## BACKGROUND AND GENERAL COMMENTS

2. We support the IASB's initiative to make a targeted and focused amendment to IFRS 9 to address a late-breaking issue about financial instruments with prepayment features that could result in their classification and measurement in a manner that would provide less useful information. It is highly important to have a well-targeted, surgical amendment that becomes effective simultaneously with IFRS 9 in order to ensure the most appropriate reporting of these financial instruments.

3. Indeed, while we understand the IFRS Interpretations Committee's (the "IFRIC") conclusions, we wish to stress that some of our members under IFRS had another understanding of the paragraph B4.1.11(b) of IFRS 9. Pursuant to this interpretation, which is similar to the one expressed as View 1 on Issue 1 in the query received by the IFRIC, the 'reasonable additional compensation' stated in paragraph B4.1.11(b) could be both ways; that is, the party that chooses to exercise the option could either pay or receive it. This may be a reason that the issue has arisen at such a late stage in IFRS 9 implementation. We will refer here to such prepayment options as symmetric prepayment options.

4. In some jurisdictions, loans with symmetric prepayment options are a common market practice.

5. For example, in Switzerland, basic mortgages and corporate loans have prepayment clauses that may result in negative compensation. Such clauses are pervasive in the market (with the affected portfolios amounting to over CHF140 billion for one of our member banks) and are required for Swiss private mortgages as a consequence of the Swiss Unfair Competition Act and for Swiss corporate loans as a consequence of market practice. Under IAS 39, such loans are carried at amortized cost.

6. Likewise, other banks carry out a significant part of their basic lending activity through financial instruments that may give rise to negative compensation. Indeed, in the current macroeconomic environment, there is strong demand from corporate clients to provide fixed-rate financial instruments that include symmetrical prepayment options. That is notably the case for loans granted to certain substantial sectors, for example the aircraft industry, or to the public sector, in some jurisdictions.

7. We believe that, given the basic features of the loans likely to be affected, amortized cost continues to provide useful information, as was the case under IAS 39. Such classification best represents the economic substance of the relevant business models for such basic lending arrangements. Furthermore, it also accords with IFRS 9's principles and the objective of providing "relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows."

8. The IFRIC's reading of paragraph B4.1.11(b) of IFRS 9 calls into question that longstanding practice. The magnitude of the issue for certain markets and products makes it imperative to remove all doubts by the time IFRS9 is implemented.

9. In the light of such concerns and to address uncertainty, we strongly support the proposal to make targeted amendments to the requirements in IFRS 9 for classification and measurement. We also believe that the timeliness and scope of the amendment are key to appropriately addressing the question raised to the IFRIC. As already stated, it is important for the IASB to complete the process as soon as possible so that the amendments can be applied with the same effective date as the standard as a whole. The amendments should be limited to what is necessary to clear up the issue of what constitutes 'reasonable additional compensation'.

10. For such a targeted and simple amendment, it should not be necessary to include additional explanatory text in the Basis for Conclusions (BC), particularly where this may de-facto create additional requirements which are not in the standard itself or may create uncertainty with regard to other aspects of the 'solely payments of principal and interest' (SPPI) notion.

## COMMENTS ON THE PROPOSED AMENDMENTS

11. We support the objective of the proposal to identify financial instruments with prepayment features for which the effective interest rate method provides useful information.

*Support of the first eligibility condition*

12. We agree that a prepayment amount that is inconsistent with paragraph B4.1.11(b) only because the prepayment option is symmetric should not result in failure to meet the conditions in paragraph B4.1.10. As already acknowledged in paragraph B4.1.11(b), featuring prepayment options is not a sufficient motive to prevent measurement at amortized cost. Further, as prepayment may constitute, either for the lender or the borrower, an opportunity cost or advantage owing to changes in the time value of money, we believe that there is no conceptual reason to consider only cases where compensation is to be paid by the party that exercises the prepayment option. Thus, prepayment features that include, in addition to the payment of principal and accrued interest, the payment or the settlement of an amount to compensate for changes in the time value of money should be considered as basic loan features. For financial instruments with such prepayment features, contractual cash flows would still substantially consist of interest and principal payments; therefore, the effective interest method is the appropriate measurement method. We believe that this could be stated explicitly as paragraph B4.1.12A(a) in the proposed amendment.

*Suggestion regarding the second eligibility condition*

13. Regarding the second eligibility condition, we fully agree that any financial instrument with an insignificant fair value of the prepayment feature would not require frequent upward and downward adjustments in its gross carrying amount. For financial instruments that would meet the second eligibility condition and other conditions set forth in IFRS 9 and proposed amendments, we believe amortized cost measurement would provide users with useful information.

14. However, we question the need for a second eligibility condition. In fact, one might argue that the first eligibility condition is self-sufficient as it would limit the exception to prepayment features altogether similar to those currently targeted by paragraph B4.1.11(b). For such financial instruments, amortized cost, as has proven to be the case under IAS 39, would be far simpler than fair value and would faithfully reflect the fact that they are designed and managed to collect cash flows that result from interest and principal payments, which borrowers' behavior has been confirming. An amendment including only the first eligibility condition would have the merits of consistency and simplicity. It would avoid introducing additional rules into the standard, including the need for transitional provisions, and additional operational requirements. Consequently, we invite the Board to consider limiting the proposed amendments to the first eligibility condition set forth in paragraph B4.1.12A(a). Should the Board deem it advisable to

do so, it would then be entirely feasible to amend IFRS 9 through a simple footnote to paragraph B4.1.11(b).

15. Although there is a reasonable case that an amendment stating only the first condition would be sufficient, the industry could accept the amendments with both conditions if doing so is necessary to assure that the amendment enters into effect at the same date as IFRS 9.

## BASIS FOR CONCLUSIONS IS UNNECESSARILY FAR-REACHING

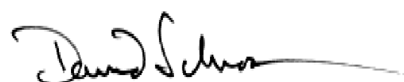
16. Lastly, we are concerned that the commentary in Basis for Conclusions is excessive compared to the amendment itself and risks creating or implying additional requirements which are not in the standard, or uncertainty with regard to other aspects of the standard.

17. For example, BC19 suggests that paragraphs B4.1.12 and B4.1.12A are mutually exclusive. There is nothing in the standard itself that states this and it seems illogical that a financial asset that is purchased after origination with a symmetric prepayment option, perhaps as a result of a business combination, should be required to be treated differently. We do not agree with this suggestion, but if it were to be required, it should be included in the standard.

18. Another example is the discussion set out in paragraphs BC18 and BC23, which goes beyond the issue at question. Specifically, we do not think that the proposed amendments warrant a wider discussion on whether prepayments at fair value or compensation that includes the cost of termination of the associated hedging might be considered as solely payments of principal and interest. Such discussion could interfere with developing practice and, given the deadlines for implementation, it would be advisable to consider whether this discussion would better form part of a post-implementation review or other later due process that would allow stakeholders to look more closely at its implications.

19. Our detailed answers to the questions are included in the appendix below. As always, we would be pleased to discuss our comments and concerns in more detail if this would be helpful. For any questions on this letter, please contact Hassan Haddou (hhaddou@iif.com; +1 202.682.7456).

Yours sincerely,



## Appendix – Responses to specific questions raised by the IASB

Drawing on arguments set forth in the cover letter, we set out below our specific comments relating to questions outlined in the invitation to comment.

**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?*

The latest conclusions of the IFRS Interpretations Committee's (the "IFRIC") about classification and measurement of financial instruments with prepayment features shed light on divergent interpretations of the paragraph B4.1.11(b) of IFRS 9. Indeed, as already mentioned, some members favored a reading of this paragraph that does not distinguish cases where compensation is to be paid from cases where compensation is to be received; that is, per this interpretation, contrary to the IFRIC's reading, so called symmetric prepayment features would be eligible to amortized cost measurement provided other required conditions are met.

We share the IFRIC's view set out in paragraph BC6 that amortized cost provides useful information whether prepayment features are symmetric or asymmetric. The issue is all the more salient since in certain sectors and jurisdictions, it is a common market practice to carry out basic lending activity through financial instruments with symmetric options. Consequently, we support the IASB's objective to provide clarification on classification and measurement of financial instruments with prepayment features.

**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 amortized 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 recognizes 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?*

As set out in paragraphs 11-15 of this letter, we support the objective of the proposed amendments to make clear that financial instruments with symmetric options might be eligible for measurement at amortized cost. As discussed in paragraph 14, we however encourage the Board to consider limiting the amendments to the first eligibility condition as stated in paragraph B4.1.12A(a) of the ED. In this case, the suggestion to the Board is to proceed through a footnote to paragraph B4.1.11(b), which would offer a simple and clean solution.

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 are deeply convinced that the exception should go hand in hand with IFRS 9 in order to avoid inappropriate reporting and disproportionate impacts on certain markets, products, and banks. Therefore, it is imperative that the effective dates of the exception and of IFRS 9 be the same and earlier application should be permitted. Consequently, we urge the Board to complete the process as soon as possible so that the exception might be effective at the same date as IFRS 9.

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?*

*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?*

We share the view that appropriate transition provisions should accompany the amendments. However, we would also stress that should the Board decide, as suggested in this comment letter, to limit the amendments to the first eligibility condition, transitional provisions would not be necessary, which would make simpler the implementation of the exception.