Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

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Berlin, 22 May 2017

Dear Hans,

IASB ED/2017/3 *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9)*

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the IASB's ED/2017/3 *Prepayment Features with Negative Compensation* (herein referred to as the 'ED'). We appreciate the opportunity to comment on this ED.

Generally speaking, a majority of our Committee members is of the view that IFRS 9 would not have required any changes. These members do not share the view that IFRS 9.B4.1.11(b) excludes financial instruments with symmetric prepayment features comprising potentially "negative" compensation. We understand and acknowledge that a majority both within the IFRS Interpretations Committee (IFRS IC) as well as on the IASB felt differently and did not believe that the current text would cater for symmetric prepayment options.

Whilst we agree with the IASB that instruments with negative compensation could be eligible for amortised cost treatment (or for FVOCI treatment, respectively) – provided the business model criterion is met –, we do not favour providing an exception to the principle in B4.1.10 / B4.1.11, which the ED effectively does, as this creates an arbitrary rule satisfying these particular instruments while there may be other instruments with different features potentially deserving a similar "exception".

Please find our respective comments in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

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Appendix – Answers to the questions of the ED and related proposals

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

We support the IASB's aim to allow instruments with prepayment features with only positive compensation ("asymmetric features") as well as those with possible positive and negative compensation ("symmetric features") being equally eligible for amortised cost measurement, or for fair value through OCI measurement, repectively.

As stated in the cover letter, a majority of our Committee members is of the view that IFRS 9 would not have required any changes. These members do not share the view that IFRS 9.B4.1.11(b) excludes financial instruments with symmetric prepayment features comprising potentially "negative" compensation and, hence, disagree with the narrow reading of the standard reproduced in BC4 et seq. of the ED.

We acknowledge that B4.1.11(b) distinguishes two components resulting from the prepayment, being (A) the amount "substantially representing unpaid amounts of principal and interest" and (B) a possible "reasonable additional compensation for the early termination". However, in our view, "additional" does not mean that (B) necessarily has the same (positive) algebraic sign as (A). Moreover, the two components that make up the total prepayment amount are different in nature and, thus, are considered separate prepayment amounts that finally add up to the total prepayment. Hence, both components may have the same or may have different algebraic signs.

Given that a majority both within the IFRS IC as well as on the IASB felt that the current text in B4.1.11(b) should be read narrowly, we agree with the IASB that B4.1.11(b) should be amended so as to allow such instruments to qualify for amortised cost treatment.

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 ED 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 IFRS 9.B4.1.11(b) 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?

Whilst we agree with the IASB that instruments with negative compensation could be eligbile for amortised cost treatment (or for FVOCI treatment, respectively) – provided the business model criterion is met –, we are concerned with the appropriateness of two criteria on which the proposed amendment is based:

1. the assessment that the "reasonable additional amount" reflects (only) the effect of a change in market interest rate (cf. BC15), 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 (cf. BC18); and
2. the second condition of an initially insignificant fair value of this prepayment feature, ie. B4.1.12A(b).

Ad 1. We do not agree with the IASB's reasoning that "reasonable additional compensation for the early termination" should only reflect the interest differential. In practice, the additional prepayment amount often includes components in addition to the interest differential, e.g. changes in credit spreads, costs for the dissolution of hedges, unrecoverable margin, administration expenses due to prepayment, etc. Even if such compensation is not the same as a "fair value compensation", it comprises several additional components, compensating for "more than" changes in the risk-free interest rate. Therefore, prepayment compensation for interest rate changes and a prepayment amount equalling fair value can, economically, be very close together (especially if other risk factors have not changed significantly). Hence, there is no justification for distinguishing instruments that are prepayable with compensation only for interest changes being eligible for amortised cost treatment, while instruments that are prepayable at fair value are not.

We believe that it would be far more appropriate to link the prepayment amount to the underlying loan agreement satisfying SPPI, i.e. the additional compensation must bear a logical relationship to the terms of the naked 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). This would make sure that the option does not pay on changes in risk factors unrelated to a loan (e.g., commodity, equity or index price risk), and it would ensure that there is no leverage.

Lastly, we have difficulty in understanding the rationale for concluding that:

i) on the one hand, instruments that are prepayable at fair value should <u>not be eligible</u> for amortised cost measurement <u>*because* they do not meet the SPPI condition</u>, ie. its compensation amount is inconsistent with B4.1.11(b) (cf. BC18), while

ii) on the other hand, instruments with (symmetric) prepayment features that may lead to the party that chooses prepayment receiving compensation should <u>be eligible</u> for amortised cost measurement <u>*although* they do do not meet the SPPI condition</u>, ie. its compensation amount is inconsistent with B4.1.11(b) (cf. BC7).

Ad 2. While we understand that this condition was introduced in order to restrict the population of instruments being eligible under the proposed exception, we do not agree with its conceptual basis (as explained in BC21 et seqq.). As any other option, a prepayment feature has an intrinsic and a time value. The latter reflects the possibility of the option becoming valuable and being in the money. Customers in our country favour entering into fixed rate agreements over a long period (10 to 15 years) with prepayment features being granted. Theoretically, the option's fair value could only ever be insignificant, if the the exercise amount was equal or very close to the fair value as at that date. In all other cases, the option *must* have value, and its value would be the higher the longer the period for which interest rates were fixed. That does not mean that there is an incentive for one party to immediately exercise the option; the value merely reflects the price for the option to become valuable over time. So what the condition, if retained, really should focus on is the *intrinsic value* of the option, which should be insignificant.

Apart from this conceptual aspect, it seems inconsistent to state that the initial fair value of a prepayment feature was crucial for instruments with symmetrical prepayment features (being eligible or not eligible under B4.1.12A), while it was not a relevant factor for instruments with asymmetrical prepayment features (being eligible under B4.1.11(b)). It appears that the condition has merely been carried over from the other (existing) exception in B4.1.12, where lit. (c) establishes the very same condition – but where this condition is fully appropriate, given the different nature of the features of instruments covered by B4.1.12. Therefore, we suggest removing the second condition, i.e. B4.1.12A(b), thus aligning the eligibility criteria for instruments with symmetric prepayment features with those for instruments with asymmetric prepayment features in B4.1.11(b).

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?

Given the requirement of endorsing IFRSs including amendments in the EU, we would not be in favour of hard-wiring an effective date of 1 January 2018, as this is likely to create issues for foreign filers. We would prefer if the IASB set the effective date at 1 January 2019 with early application permitted instead.

Question 4 – Transition

For the reasons set out in paragraphs BC27–BC28, the ED 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 ED 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 ED? If so, what are those considerations?

Assuming an effective date at 1 January 2019, as suggested above, we do not see the need for additional transition provisions.

That being said, we would expect entities to carefully consider the provisions in IAS 8 on standards adopted but not yet effective when preparing and communicating financial statements. We believe this to be particularly relevant for those entities that prepare interim financial statements in 2018, where there may be an unavoidable effect in communicating IFRS 9 balances and changes in these balances in 2018, based upon the current text, and reversing those effects when applying the amendment in 2019.