IASB
30 Cannon Street
London
EC4M 6XH

Submitted electronically

17 May 2017

Dear Sirs

Exposure Draft ED/2017/3 *Prepayment Features with Negative Compensation*

I am writing on behalf of the UK Financial Reporting Council (FRC) to comment on the Exposure Draft ED/2017/3 *Prepayment Features with Negative Compensation*.

We agree with the key proposal of the Exposure Draft that financial assets with symmetric prepayment features should be permitted to be measured at amortised cost or at fair value through other comprehensive income. However, we suggest the following:

- Deleting the second condition applying to the proposed exception;
- Reconsidering the usefulness of the interpretative guidance on aspects of IFRS 9 *Financial Instruments, removing those parts* which are outside of the scope of the amendment; and
- Making improvements to the transitional provisions.

Our responses to the questions are included in the Appendix to this letter.

If you would like to discuss these comments, please contact me or Susanne Pust Shah (s.pustshah@frc.org.uk) on 020 7492 2495.

Yours sincerely

Paul George
Executive Director
Corporate Governance and Reporting
DDI: 020 7492 2340
Email: p.george@frc.org.uk

Appendix: 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?

A1 The FRC agrees with the conclusion in paragraph BC6 of the Exposure Draft that financial assets with prepayment features that may result in negative compensation should be permitted to be measured at amortised cost or at fair value through other comprehensive income because measurement on those bases provides useful information.

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?

A2 The FRC agrees with condition (a). However, we believe condition (b) should be deleted

A3 The rationale given for including condition (b) is not convincing. We note that in paragraph BC22 the IASB explains that the condition is included in order to limit the application of the proposed exception to financial assets where the prepayment is unlikely to occur. The same condition does not apply to instruments with asymmetric prepayment options and it is therefore not clear why this condition is needed for instruments with symmetric prepayment options. We would generally expect that an instrument that meets condition (a) will also meet condition (b). We are therefore unsure which additional instruments the IASB is intending to exclude by adding this condition.

A4 We also have the following two concerns about how condition (b) would be applied in practice:

a. There may be significant practical difficulties with the determination of an IFRS 13 *Fair Value Measurement* compliant fair value for the prepayment feature.

b. The exception in draft paragraph B4.1.12A applies to financial assets with symmetric prepayment options under which negative compensation may be payable. However, the fair value of the prepayment feature determined in accordance with this condition includes the fair value of the asymmetric portion of the prepayment option under which positive compensation may be payable. This may have a distortive effect and the total fair value may not be reflective of the fair value of the negative compensation component on its own.

A5 The FRC notes the additional explanations provided in paragraph BC18 on what type of prepayment amounts are inconsistent with paragraph B4.1.11(b) of IFRS 9 as follows:

a. a prepayment amount at the current fair value of the financial asset; and

b. a prepayment amount that includes the cost to terminate an associated hedging instrument.

A6 The FRC is concerned that these additional explanations and the supporting arguments imply broader interpretative conclusions beyond those necessary to support the amendments. In particular, the general interpretations of the meaning of reasonable compensation may disrupt work done to date and still on-going on the classification of a broader set of financial instruments.

A7 The IASB acknowledges in paragraph BC8 that amending IFRS 9 shortly before the impending effective date of the standard could disrupt implementation efforts. The FRC shares this concern and we believe that the interpretative guidance in paragraph BC18 amplifies this risk unnecessarily and should have been avoided. We request the IASB to reconsider its Basis for Conclusions, removing those additional explanations in BC 18 which are not necessary to justify the amendments to IFRS 9 and will create uncertainty and disruption to implementation efforts at this late stage.

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?

A8 In paragraph BC26 the IASB acknowledges that there may not be sufficient time between the issue of the amendment and the effective date for endorsement activities to be completed.

A9 Endorsement of this amendment in the European Union may not be completed before 1 January 2018. The FRC therefore proposes an effective date for the amendment of 1 January 2019, with an early application option.

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?

A10 It is our understanding of draft paragraph 7.2.5A that when it is impracticable to determine whether the fair value of the prepayment feature was insignificant at initial recognition, the financial asset has to be measured at fair value through profit or loss. We note that the transitional provision therefore would not provide relief from fair value measurement, but is rather a clarification that the options to measure the asset at amortised cost or fair value through other comprehensive income would not be available.

A11 To provide some transitional relief we suggest a transitional provision that permits the assessment as of the date of adoption of the amendment instead of at the date of inception. We acknowledge, however, that this would be a departure from the transitional provision of paragraph 7.2.5 of IFRS 9 in respect of prepayment features in financial assets that were acquired or originated at a premium or discount but consider the inconsistency between these reliefs is justified given the specific circumstances of this late amendment..

A12 In this letter we have set out our concerns regarding condition (b) of draft paragraph B4.1.12A, to which the transitional provision in draft paragraph 7.2.5A relate. Depending on whether the IASB amends draft paragraph B4.1.12A, the transitional provisions may require some consequential amendments.

A13 We are concerned that the interaction between the requirements of paragraphs 7.2.15 and 7.2.27 of IFRS 9 and draft paragraph 7.1.7 may be confusing. Paragraph 7.2.27 restricts the availability of the exemption of paragraph 7.2.15 from restatement of prior periods in respect of the classification and measurement of financial assets to a one-time only application.

A14 In a situation where an entity applies IFRS 9 before it applies the amendment, for example it is unable to do so because the amendment is not yet endorsed in the local jurisdiction, the following may occur. The entity will not restate prior year comparatives on adoption of IFRS 9 on 1 January 2018 in accordance with paragraph 7.2.15. However, when the entity adopts the amendment at a later date, say mid-year, the same

relief is no longer available in accordance with paragraph 7.2.27. The entity has to restate the comparatives for the financial assets covered by the amendment.

A15 If our understanding is correct we believe transitional relief from restatement should be granted. Entities that apply the amendment during the financial year commencing on or after 1 January 2018 should be in the same position as those that apply the amendment and IFRS 9 together.