ISDA Safe, Efficient Markets

European Financial Reporting Advisory Group
35 Square de Meeûs
1000 Brussels
Belgium
By email to: commentletters@efrag.org

24th May 2017

Dear Sirs,

Ref.: EFRAG's Public Consultation – IASB's ED/2017/3 on Prepayment Features with Negative Compensation

The International Swaps and Derivatives Association ("ISDA")[1] is pleased for the opportunity to respond to the above referenced Public Consultation on the Exposure Draft ('ED') issued by the International Accounting Standards Board ("IASB").

Further to the advanced comments submitted to EFRAG's Staff on 17th May 2017 as it was requested, please, find below the appendix to this letter with the final response comment letter to the IASB's ED, with our members' view on the referenced topic.

Yours faithfully,

Lisa Bomba
Chair of ISDA's European Accounting Committee
Managing Director
Head of Accounting Policy & Advisory Group
Deutsche Bank AG

Antonio Corbi
Director
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ISDA, Inc

Appendix: ISDA's comment letter submission to the IASB's ED/2017/3

[1] Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 850 member institutions from 68 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA Safe, Efficient Markets

International Accounting Standards Board
1st Floor
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By email

24th May 2017

Dear Sirs,

Ref.: IASB ED/2017/3 Prepayment Features with Negative Compensation

The International Swaps and Derivatives Association ("ISDA")[1] is pleased for the opportunity to respond to the above referenced Public Consultation on the Exposure Draft ('ED') issued by the International Accounting Standards Board ("IASB").

Key Messages:

Our members appreciate the efforts of the IASB ("the Board") to seek to find a solution for loans containing prepayment features that could result in negative compensation. Such loans are common and we agree with the Board that their measurement at amortised cost provides more relevant information where they would only fail the SPPI conditions because the compensation in the event of prepayment may be negative

It is important that this issue is dealt with urgently, given that the IFRS 9 application date is only seven months away for most banks. In view of this timetable, our members believe it is important for the Board to limit any amendments made to IFRS 9 and, more specifically, to matters necessary to address the issue that was submitted to the IFRS Interpretations Committee. They do not think it is appropriate for the Board to add more interpretative guidance by means of additional Basis of Conclusions paragraphs into the literature, which could have unintended consequences for other financial instruments.

In particular, our members are concerned about the implications of paragraph BC 18, that a loan prepayable at fair value would not meet the SPPI conditions, even if compensation is

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only positive. They are concerned because this could be read to mean that there would be a similar problem if a loan is prepayable at an amount based on changes in a benchmark rate plus credit spread, since the majority of the changes in a loan's fair value is driven by just these two components. Loans which prepay based on changes in a benchmark rate plus credit spread, or on changes in the benchmark rate only, are common for many prepayable loans with only positive compensation.

Prepayment at a value which includes both the change in the benchmark rate and the credit spread puts the lender in economically the same position as if it had taken the proceeds and reinvested them in a loan with the same terms as the one prepaid. This is consistent with BC14(a), which refers to 'an amount "which will compensate the borrower for having to pay a higher rate if it enters into a similar arrangement". Further, BC15 refers to 'the relevant market interest rate', without defining it. A natural reading of this phrase would assume that it is a rate which includes credit spread and the other features that a market participant would take into account in calculating the fair value of a financial instrument. Indeed, the net present value of the change in the relevant market interest rate is in many cases the change in the instrument's fair value.

Consequently our members request that most of the BC section of the proposed amendments is deleted. If BC18 is not deleted it should at least be amended to make it clear that compensation may include not only the change in a benchmark rate but also the credit spread.

Most of our members also have considerable concerns with the second condition, set out in proposed paragraph B4.1.12A(b), that the fair value of the prepayment option has insignificant fair value on initial recognition. With this condition the amendment is very narrow and may mean that many common plain vanilla loans will be required to be recorded at fair value through profit or loss, such as where compensation is calculated by reference to a collateralised vanilla interest rate swap.

It will also impose an operational burden. Consistent treatment of positive and negative compensation arrangements would result in a more principled standard, would allow more plain vanilla instruments to benefit from the amendment and would ease transition and endorsement by the EU. Therefore these members believe that the amendment should be limited to permitting negative as well as positive compensation, as long as it is reasonable compensation.

Yours faithfully,

Lisa Bomba Chair of ISDA's European Accounting Committee Managing Director Head of Accounting Policy & Advisory Group Deutsche Bank AG	Antonio Corbi Director Risk and Capital ISDA, Inc

Appendix – Responses to specific questions raised by the IASB

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

Our members agree with the concerns as stated. There are a significant number of financial instruments that have prepayment features with negative compensation that otherwise meet the SPPI conditions and are regarded as relatively simple and normal 'plain vanilla' instruments, as described in paragraph BC16 of the ED. Measuring these instruments at fair value through profit or loss (FVPL) would not provide more useful information than amortised cost or fair value through other comprehensive income.

Symmetrical prepayment arrangements are often included in loan agreements, not as a means to allow the borrower to speculate on interest rates, but to provide more equitable settlement should the customer's circumstances change and the loan is no longer required. In the case of some mortgages these arrangements are required by law and for many products they are a consequence of market practice.

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?

Many of our members have concerns with the proposal as drafted.

A. The condition that the initial fair value of the prepayment feature is insignificant

Our members agree with the first condition but many of our members regard the second (proposed paragraph B4.1.12A(b)) as lacking a technical justification and as unnecessarily restrictive. The second condition will have the counterintuitive effect that instruments are most likely to meet it if the prepayment would be at fair value, which according to BC18 would not qualify for the exception, see below. Indeed, these members are concerned that a large number of 'plain vanilla' corporate loans may not qualify. For instance, as acknowledged in BC24, the prepayment option in a loan that may be prepaid by the borrower at an amount based on the present value of a benchmark rate may have a fair value on original recognition that is not insignificant, because the borrower would not be compensated for movements in the borrower's credit spread. Moreover, it will be operationally challenging for banks to have to determine whether the second criterion is met for all loans that allow negative compensation and not just those to which paragraph B4.1.12 applies.

The reason set out in BC21 for including the second criterion is to minimise the occurrence of B5.4.6 adjustments. Many of our members have three main concerns with this.

First, prepayable assets that would meet the requirements of B4.1.11 even without this amendment may show catch-up adjustments in accordance with B5.4.6. This will be the case whenever there are significant costs or fees associated with the asset, or an introductory low rate of interest followed by a step up in the rate, requiring the calculation of a 'blended' effective interest rate, as is common with many mortgage products. There will be B5.4.6 adjustments whenever there are changes in prepayment assumptions.

Second, the fair value of a prepayment option is not a good measure of the likelihood of it being exercised, as borrowers do not normally chose to prepay in order to make fair value gains but for operational purposes or to manage their interest rate costs. If a prepayment option has an insignificant fair value this may be because prepayment is not expected but will also be the case if the lender is indifferent to its occurrence, such as when prepayment is at fair value.

Third, it is not clear to these members why there is a proposed condition that the fair value of the prepayment option is not significant on original recognition for two way compensation arrangements, given that there is no similar condition for one way arrangements, unless B4.1.12 applies.

The proposed condition will also make transition more difficult and may impede endorsement by the EU (see Questions 3 and 4).

In summary, many of our members consider that the condition set out in proposed paragraph B4.1.12A(b) is not necessary and should be removed from the proposed amendment. They do not believe an alternative condition is required.

B. Prepayment at fair value

Although BC18 makes it clear that a prepayment at fair value would not be reasonable compensation, our members are concerned that such an important element of the Board's thinking is introduced through a BC. It will, of course, be equally relevant for any instrument which can be prepaid at fair value where there is no negative compensation. This guidance goes beyond a narrow scope amendment and our members are concerned as to why it is needed – especially at this late stage, so close to application of the standard - given that the topic of the ED is prepayment features with negative compensation, rather than what constitutes reasonable compensation.

Our members would prefer the references to prepayment at fair value in the BC to be deleted. But should they be retained, they are concerned because this could be read to mean that there would be a similar problem if a loan is prepayable at an amount based on changes in a benchmark rate plus credit spread, since the majority of the changes in a loan's fair value is driven by just these two components. However, compensation based on the change in benchmark rate and credit spread is relatively common and is regarded by lenders and borrowers as reasonable compensation. Should they be retained, our members request that it is clarified that the references to fair value are not intended to include prepayment based on the change of a collateralised interest rate swap plus the borrower's credit spread.

This approach would be consistent with BC15 which refers to 'the relevant market interest rate', without defining it. A natural reading of this phrase would assume that it is a rate which includes both the benchmark rate and the credit spread. It is also supported by BC14(a), which refers to an amount which "will compensate the borrower for having to pay a higher rate if it enters into a similar arrangement", which would encompass both the change in benchmark rate and credit spread, although BC 24 provides as an example of a 'relevant market interest rate' only the benchmark rate. It would be helpful if it were made clearer that the relevant market rate may include both the benchmark rate and the credit spread.

C. Prepayment at an amount that includes the fair value of a hedging instrument

The wording of paragraph BC18 on financial assets that are prepayable at an amount that includes the fair value of an associated hedging instrument, is ambiguous. As worded, it implies that some such arrangements will qualify for SPPI, without saying what these are. If the Board has in mind that prepayment based on the fair value of plain vanilla, collateralised interest rate swaps (which therefore are not exposed to the credit risk of the swap counterparties) would qualify, it would be helpful to make this clear by way of guidance.

It is important that arrangements including the prepayment value of a hedging instrument should qualify to be recorded at amortised cost, since not only are they common, but this is often the most practical, fair and unambiguous method of determining the net present value of a change in a benchmark interest rate.

It is therefore of concern to many of our members that, according to BC 24, instruments where the prepayment compensation is based on the fair value of such a swap, may not meet the SPPI conditions because the fair value of the prepayment option is not insignificant at the outset (see A. above).

D. The two exceptions are exclusive

BC19 requires that an entity may not apply both B4.1.12 and B4.1.12A, without making it clear why this should be so. Our members are concerned that, without this ability, plain vanilla instruments that will be able to be recorded at amortised cost because of the proposed amendment, will not qualify if acquired subsequent to origination. Not only will this affect purchases in the secondary market but also business combinations. It is possible that a takeover of one bank by another may require a significant portion of the acquiree's balance sheet to be subsequently recorded at FVPL in the acquiror's accounts.

The inability to apply both exceptions would, as worded, also appears to mean that any financial asset that is prepayable with negative compensation would not qualify as SPPI if acquired when distressed. This does not make sense: if a borrower is in financial difficulty they will be very unlikely to prepay, yet this treatment is implied by the example provided in

BC19, which refers to the asset being acquired "at a significant discount to the contractual par amount". Consistent with the principles of the SPPI criterion, it should be possible to be able to ignore the prepayment feature if it no longer has commercial substance, and it would be helpful if this were made clear.

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

Our members agree with the proposed effective date. However, as noted in response to question 2, there are a number of difficulties with the proposed criteria and views expressed in the BC, and it may be necessary to amend the criteria to help ensure that the amendments are endorsed by the EU in time to be applied when IFRS 9 is first applied.

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 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?

Our members agree with the proposed transition provisions, although they could be simplified if the conditions proposed in paragraph B4.1.12A (b) were omitted.

Other comments

Much of the guidance in the proposed amendment is contained in the BC. For instance, it is only in the BC (BC 18) that it is said that prepayment at fair value would not meet the SPPI conditions. Guidance of this importance should usually be included in the standard, but given that this does not relate to matters necessary to address the issue that was submitted to the IFRS Interpretations Committee, our members would prefer it not to be included in the amendment at all.