Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Sent electronically through the IASB Website (www.ifrs.org)

7 June 2017

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

Dear Hans,

IASB Exposure Draft ED/2017/3
Prepayment Features with Negative Compensation
– Proposed Amendments to IFRS 9

The Hong Kong Institute of Certified Public Accountants ("HKICPA") is the only body authorised by law to set and promulgate standards relating to financial reporting, auditing and ethics for professional accountants, in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Exposure Draft.

The HKICPA supports the IASB's initiative to address the concerns about prepayment features with negative compensation. Stakeholders from the banking industry informed us that loans with prepayment features that may result in negative compensation are common in Hong Kong.

The HKICPA considers that financial assets with prepayment options that result in positive or negative compensation could still reflect 'interest' in a lending arrangement. This is because the change in market interest rate that leads to positive or negative compensation upon early termination could be considered other basic lending risks. Viewed in another light, prepayment terms that are linked to changes to market interest rate may not necessarily introduce volatility or exposure to risks in the contractual cash flows that are unrelated to basic lending arrangements. Changing the sign of the compensation does not change the characteristics of the cash flows of the financial assets. On this basis, the HKICPA thinks that the principle of 'Solely Payments of Principal and Interest' (SPPI) could still be met.

Having said that, the HKICPA does not support the IASB's proposal to create an exception to a principles-based standard. The HKICPA believes that doing so would undermine the conceptual underpinning of the classification principles and would create confusion on the application of the principles. Instead of creating an exception, the HKICPA strongly recommends that the IASB clarifies the application of the classification principles to prepayment features with negative compensation, for example by clarifying in paragraph B4.1.11(b) that the reasonable additional compensation for early contract termination can be both positive or negative, and explain the IASB's rationale in the Basis for Conclusions.

If the IASB were to retain its proposal to create an exception to IFRS 9, the HKICPA would support the first eligibility condition as proposed in paragraph B4.1.12A(a) of the ED. The HKICPA does not support the second eligibility condition because there seems to be little justification for it.

The HKICPA's and our stakeholders' responses to the questions raised in this ED are explained in more detail in the Appendix.

If you have any questions regarding the matters raised in this letter, please contact me or Eky Liu, Associate Director of the Standard Setting Department (eky@hkicpa.org.hk).

Yours sincerely,

Christina Ng
Director, Standard Setting Department

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Work undertaken by the HKICPA

In forming its views, the HKICPA:

(i) issued an Invitation to Comment on ED/2017/3 on 27 April 2017 to our members and other stakeholders;

(ii) reached out to the Hong Kong Association of Banks (HKAB);

(iii)sought input from its Financial Instruments Advisory Panel and Banking Regulatory Advisory Panel, which comprise technical and industry experts from large accounting firms (practitioner) and bank representatives; and

(iv)developed its views through its Financial Reporting Standards Committee, having reflected on its stakeholder views. The Committee comprises academics, preparer representatives from various industry sectors, regulators, as well as technical and industry experts from small, medium and large accounting firms.

This submission outlines HKICPA's views as well as most of our stakeholders' comments on ED/2017/3.

Detailed comments on IASB ED/2017/3

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?

(A) Stakeholders' views

The HKAB observes that it is a pervasive market practice in Hong Kong for loans to contain prepayment features with negative compensation. Most of these loans are regarded as relatively simple and 'plain vanilla' instruments, and accordingly measuring performance of such loans at fair value through profit or loss would not be useful and meaningful to users of financial statements. Therefore, the HKAB agrees that the IASB should address the concerns raised.

Most other stakeholders also agree that the concerns raised about prepayment features with negative compensation should be addressed. They think that it is necessary to provide clear guidance in the standard as to whether prepayable financial assets with negative compensation could be measured at amortised cost or fair value through other comprehensive come (FVOCI) in order to avoid diversity in practice.

One practitioner considers that it is clear that the requirements of IFRS 9 would lead financial assets with negative compensation prepayment features to be measured at fair value through profit or loss. This practitioner considers such measurement basis to be appropriate and does not see any compelling reasons for amending the standard to address the concerns raised.

(B) HKICPA's analysis and recommendation

The HKICPA notes that paragraph B4.1.11 of IFRS 9 addresses situations where financial assets have prepayment options. However, it is not clear whether and how paragraph B4.1.11 applies to financial assets containing prepayment features with negative compensation, in particular, whether 'reasonable additional compensation' could include negative compensation.

In light of the above, the HKICPA supports the IASB's initiative to address the concerns raised about the classification of prepayable financial assets with negative compensation.

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?

(A) Stakeholders' views

Whether amortised cost is the relevant measure for prepayable financial assets with negative compensation?

Most stakeholders, including the HKAB, consider that amortised cost is the more relevant measure for prepayable financial assets with negative compensation as it does not change the characteristics of the contractual cash flows. They consider that the negative sign of the cash flows arising from the prepayment features should not be the sole reason preventing financial assets from being measured at amortised cost. Accordingly, these stakeholders support the rationale underlying the first eligibility condition in paragraph B4.1.12A(a) of the ED.

One practitioner believes that the financial assets discussed in the ED meet the SPPI test under IFRS 9 and are basic lending arrangements. Therefore, amortised cost is the relevant measure for such financial assets and that the proposed amendments should be an application of SPPI principle.

Another practitioner does not support the proposal as he sees little grounds to support the ED as compared to the alternative view in the ED. In addition, he found it hard to conclude whether effective interest method, and thus amortised cost measurement provides useful information of the financial assets as discussed in the ED while the discussion about the application of effective interest method to floating rate instruments is still pending.

Second eligibility condition – the fair value of the prepayment feature is insignificant at initial recognition

The HKAB disagrees with the second eligibility condition proposed in paragraph B4.1.12A(b) of the ED because it is not convinced by the IASB's rationale. Paragraph BC 21 of the ED states that the purpose of the second eligibility condition is to minimise the likelihood of prepayment and therefore the occurrence of catch-up adjustments. However, the HKAB notes that even without the prepayment features, there could be multiple catch-up adjustments over the term of a loan when applying the effective interest method. This is the case for products with stepped interest rate features or where changes in actuarial life assumptions impact the period over which the loan is amortised. Therefore, it does not find the reason in paragraph BC 21 to be strong enough to support the second eligibility condition.

The HKAB notes that paragraph B4.1.11(b) of IFRS 9 already addressed the classification of financial assets with prepayment options. It believes that all contingent features, no matter whether it is positive or negative compensation, should be assessed in a consistent manner.

One practitioner also disagrees with the second eligibility condition for the following reasons:

- On the basis that the proposal is an application of the underlying principles of IFRS 9, there should not be any restrictions of applying the principles.
- Catch-up adjustments are an inherent feature of the amortised cost measurement and are commonly applied to loans today. The frequency of catch-up adjustments should not be a sole indicator of whether amortised cost provides a relevant measurement of the prepayable financial assets addressed in the ED.
- Depending on particular economic environment and the contractual terms of the financial assets, there may be scenarios in which fair value of a prepayment feature is significant at initial recognition even though the prepayment amount is consistent with SPPI principle. For example, a fixed rate loan with symmetric prepayment feature that compensates for a change in market interest rate may be able to meet the second eligibility condition when a bank originates it. However, this may not be the case when a bank acquires such a loan, either in a business combination or an asset acquisition, some time later. If the market interest rates have changed since origination, the fair value of the prepayment feature will likely be no longer insignificant when the loan is acquired. The bank may originate and manage similar loans in the same way as its acquired loans. However, because the fair value of the prepayment features of the acquired loans are not insignificant at initial recognition, they are measured differently. This would result in a lack of comparability between originated and acquired loans, which in turn reduce the usefulness of financial statements and may lead to practical implementation problems.

Additional guidance about reasonable additional compensation in BC 18

One practitioner disagrees with the following statements in paragraph BC 18 of the ED:

> *"the Board concluded that a fair value amount is not reasonable compensation for the early termination of the contract……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……"*

This practitioner thinks that a prepayment at fair value or at the cost for terminating an associated hedging instrument, in some situations, may meet the SPPI principle. This is the case if the change in fair value reflects only changes in market interest rates because there have been no significant movements in credit spread. Furthermore, in some contracts, the compensation element is limited to the effect of a change in only the benchmark component of market interest rate, which would be considered as reasonable additional compensation. This practitioner is also concerned that the conclusion made in BC 18 seems to apply equally to prepayment features with positive compensation and this could disrupt the implementation of the standard given the impending effective date of IFRS 9. Therefore, he recommended that the IASB removes such guidance.

Another practitioner and the HKAB also find the same statement in BC 18 confusing and not helpful because it does not explain clearly whether the contractual term of 'fair value cost to terminate an associated hedging instrument' is or is not compatible with the SPPI principle. In particular, the HKAB would like to understand further how the conclusion in BC 18 applies to products that include two-way hedge unwind cost clauses[1] that are common in Hong Kong.

Whether the classification is mandatory or a choice

One practitioner is confused about the phrase 'is eligible to be measured at' in paragraph B4.1.12 and B4.1.12A of the ED. That practitioner thinks that the classification of a prepayable financial asset should be mandatory if it meets the conditions set out in the ED. However, the phrase 'is eligible to' implies that it is a choice. Therefore, he thinks that the IASB should clarify this clearly in the standard.

(B) HKICPA's analysis and recommendation

The HKICPA considers that financial assets with prepayment options that result in positive or negative compensation could still reflect 'interest' in a lending arrangement. This is because the change in market interest rate that leads to positive or negative compensation upon early termination could be considered other basic lending risks. Viewed in another light, prepayment terms that are linked to changes to market interest rate may not necessarily introduce volatility or exposure to risks in the contractual cash flows that are unrelated to basic lending arrangements. Changing the sign of the compensation does not change the characteristics of the cash flows of the financial assets. On this basis, the HKICPA thinks that the SPPI test could still be met.

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1. Two-way hedges refer to situations where gains or losses associated with the unwinding of a hedging instrument is passed on to the borrower. The unwinding may be triggered by a prepayment in the underlying loan.

Having said that, the HKICPA does not support the IASB's proposal of creating an exception to a principles-based standard. The HKICPA believes that doing so would undermine the conceptual underpinning of the classification principles. Instead of creating an exception, the HKICPA strongly recommends that the IASB clarifies the application of the classification principles to prepayment features with negative compensation. The IASB could do so by clarifying in paragraph B4.1.11(b) that the reasonable additional compensation for early termination of contract can be both positive or negative. The IASB should also explain in the Basis for Conclusions the justification for why amortised cost is a relevant measure of prepayable financial assets with negative compensation.

If the IASB were to retain its proposal to create an exception to IFRS 9, we would support the first eligibility condition as proposed in paragraph B4.1.12A(a) of the ED based on the reasons stated above.

However, the HKICPA does not support the second eligibility condition because there seems to be little justification for it. The HKICPA understands that the second eligibility condition aims to limit the scope of the proposed amendment to financial assets that are unlikely to result in prepayment with negative compensation. However, the HKICPA notes that such restriction currently only applies to prepayable financial assets that were acquired or originated at a premium or discount to the contractual par amount in paragraph B4.1.12 of IFRS 9 which has been justified based on the circumstances of the financial assets. This condition does not apply to prepayment features with positive compensation in paragraph B4.1.11(b). In addition, the HKICPA is aware of its stakeholders' comments that there may be situations where fair value of a prepayment feature is not insignificant at initial recognition but amortised cost may still be a relevant measure of the financial asset.

If the IASB were to retain the proposed second eligibility condition, the HKICPA urges the IASB to obtain sufficient evidence to make sure that the second eligibility condition does not inappropriately exclude financial assets for which amortised cost is a relevant measurement. The IASB should also explain in the Basis for Conclusions how the concerns raised above will not result in unintended consequences.

In addition, the HKICPA strongly recommends that the IASB clarifies the concerns raised by its stakeholders about paragraph BC 18 of the ED and whether the measurement is a choice.

<u>Question 3 – Effective date</u>

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 adoption 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?

Stakeholders' views and HKICPA's analysis and recommendation

The HKICPA and our stakeholders agree with the proposed effective date. It would be inefficient for entities to change the classification and measurement of financial assets containing prepayment features with negative compensation after IFRS 9 is effective.

<u>Question 4 – Transition</u>

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?

Stakeholders' views and HKICPA's analysis and recommendation

The HKICPA and our stakeholders agree with the proposed retrospective application of the amendments and the proposed transition provision if the IASB retains its proposals. We do not have any comments on additional transition considerations for entities that have already applied IFRS 9 before they apply the proposed amendments.

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