KPMG

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Financial instruments

IFRS Newsletter

"We support the IASB's goal of speedy finalisation of the prepayment amendments. Addressing the numerous issues raised in the comment letters next month will require focused effort."

– Chris Spall
KPMG's global IFRS financial instruments leader

The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB's discussions in June 2017.

Highlights

Prepayment features with negative compensation

- The Board discussed the feedback received in comment letters on the Exposure Draft (ED) *Prepayment features with Negative Compensation*.
- It agreed on a project plan to re-deliberate key issues at the July Board meeting with a view to issuing final amendments in October 2017.

Dynamic risk management

The IASB staff presented an education session to the Board in which it discussed the main events that impact the composition of the dynamic risk management (DRM) portfolio, the actions taken in response to those events and the relevant information that could be considered for financial reporting.

The Board did not make any decisions, but generally agreed with the staff's summary of events that result in changes to the DRM portfolio.

Contents

Prepayment features with negative compensation

The story so far…

For a financial asset that is a debt instrument to be eligible for measurement at amortised cost or at fair value though other comprehensive income (FVOCI), IFRS 9 requires the contractual cash flows to meet the 'solely payments of principal and interest' (SPPI) criterion.

For contractual terms that permit the borrower to prepay a debt instrument (or permit the lender to put a debt instrument back to the borrower before maturity), IFRS 9 states that the contractual cash flows meet the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may include reasonable additional compensation for early termination of the contract.

In November 2016, the IFRS Interpretations Committee discussed the classification of debt instruments that include symmetric 'make-whole' prepayment options or fair value prepayment options. Most Committee members believed that such debt instruments fail to meet the SPPI criterion. This is because the borrower can choose to prepay and the lender can be forced to accept less than the amount of outstanding principal and interest. They believed that the SPPI criterion accommodates only instruments for which the party exercising its option to terminate the contract compensates, or pays a prepayment penalty to, the other party.

In November 2016, the Committee suggested that the Board consider changing the requirements of IFRS 9 in this area.

At its meeting in December 2016, the Board agreed to add a narrow-scope project to its agenda to consider amending IFRS 9 to allow particular financial assets with symmetric make-whole prepayment options to be measured at amortised cost or FVOCI.

In January 2017, the Board discussed a narrow exception for symmetric prepayment options that would have met the existing prepayment requirements in IFRS 9 except for the fact that they could incur "reasonable negative compensation for the early termination of the contract". In addition, for a financial asset with such a symmetric prepayment option to be measured at amortised cost or FVOCI, the fair value of the prepayment feature should be insignificant on initial recognition of the asset.

Having agreed at its February meeting that an ED should be issued with a 30-day comment period, the Board then issued an ED in April 2017 proposing a narrow-scope amendment to IFRS 9 – to allow financial assets with 'prepayment features with negative compensation' to be measured at amortised cost or FVOCI if certain conditions are met. The Board aims to issue a final amendment in Q4 2017 – i.e. before IFRS 9 becomes effective.

Comment letter feedback indicated that stakeholders were broadly in support of amendments to address the concerns raised.

Summary of comment letters

What's the issue?

The ED proposed that particular prepayable financial assets that would otherwise meet the SPPI criterion were it not for the prepayment feature, would be eligible to be measured at amortised cost or FVOCI – subject to the business model assessment – if the following conditions are met.

– The party that chooses to terminate the contract early (or otherwise causes the early termination to occur) may receive additional compensation for doing so – referred to as the 'first eligibility condition'.

– The fair value of the prepayment feature is insignificant on initial recognition of the financial asset – referred to as the 'second eligibility condition'.

The ED also proposed an effective date the same as IFRS 9 – i.e. annual periods beginning on or after 1 January 2018. The proposed amendment would be applied retrospectively subject to a specific transitional provision, which would apply if it was impracticable to measure the fair value of the prepayment feature on the basis of the facts and circumstances at initial recognition.

What was discussed?

The Board was presented with a summary of the feedback received:

– in 60 comment letters on the ED; and

– at the Accounting Standards Advisory Forum meeting in April 2017.

Feedback was received in the following areas.

Support for amendments to address the concerns raised

Most respondents supported the Board's efforts to address the concerns raised about the classification of particular financial assets with prepayment features that may result in negative compensation. They believe that these prepayable assets should be eligible to be measured at amortised cost or FVOCI if they do not meet the SPPI criterion only because the compensation amount is 'negative' rather than 'positive'. Some respondents stated that these features are intended to provide protection for the parties to the loan contract against changes in interest rates in the event of prepayment and are not used as a way to allow speculation on interest rates or introduce leverage. Many respondents believed that the proposals are not an 'exception' to the requirements in IFRS 9 – i.e. negative compensation can still be consistent with the notion of a 'basic lending arrangement' and the resulting cash flows can meet the SPPI criterion.

Most respondents agreed that the amendments should have a narrow scope. Based on feedback from respondents, these types of prepayable assets are common in Europe, Australia and North America, and have been observed in some aircraft-financing loans, retail mortgages, non-retail loans and loans granted by credit unions and banks in these jurisdictions.

First eligibility condition

Nearly all respondents agreed with the first eligibility condition. However, many expressed concerns that the basis for conclusions to the ED seems to interpret or provide additional guidance on the meaning of 'reasonable additional compensation for the early termination of the contract'. This guidance relates to the classification of instruments that are prepayable at their current fair value and instruments that are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument. The respondents believe:

- such guidance is unnecessary, outside the scope of the amendments and could have unintended consequences on the accounting for other instruments that the ED did not intend to address;
- entities implementing IFRS 9 have already exercised their judgement on what is 'reasonable additional compensation for the early termination of the contract' and providing additional guidance could disrupt entities' implementation of IFRS 9; and
- it is inappropriate to provide guidance on such an issue in the basis for conclusions.

Second eligibility condition

Respondents had mixed views on the second eligibility condition. Some supported it but more than half disagreed and recommended that it be deleted. One of the reasons is that it would create asymmetry – i.e. IFRS 9 does not require entities to assess the fair value of prepayment features with positive compensation. Other reasons given included the following.

- Catch-up adjustments to the gross carrying amount to reflect actual and revised estimated contractual cash flows are an inherent feature of the amortised cost method and are already required for prepayment features with positive compensation. Seeking to limit an increase in their frequency does not justify this condition.
- The fair value of a prepayment feature could be more than 'insignificant' if the asset is acquired in the secondary market or in a business combination and market interest rates have moved since the asset was originated.
- Determining the fair value of the prepayment features would be difficult and the added cost and complexity of applying the condition would outweigh any benefit it provides.

Some respondents expressed the view that the second eligibility condition would not achieve the Board's stated objective, which is to restrict the scope of the amendments so that financial assets are eligible to be measured at amortised cost only if it is unlikely that prepayment – and therefore negative compensation – will occur. This is because:

- the exercise of such prepayment features is often a business decision rather than a decision triggered by economic incentives such as fair value gains;
- the fair value of the prepayment feature will also reflect the probability that positive compensation will occur;
- the fair value of the prepayment feature could be more than insignificant, even if the probability of exercise is low; and

- the fair value of the prepayment feature could still be insignificant even if it is likely that the feature will be exercised.

Interaction with the exception for certain prepayment features at par

Many respondents expressed concerns about the interaction between the existing exception that is applicable to assets that are acquired at a premium or discount but are prepayable at the contractual par amount and the exception proposed in the ED. They believe the conditions for those exceptions should not be mutually exclusive and that an entity should be able to apply both exceptions to a single financial asset to apply amortised cost measurement.

Proposed effective date

Respondents had mixed views on the proposed effective date. Many agreed with the proposal. However, some respondents (particularly those in jurisdictions with translation and/or endorsement processes) preferred a later effective date – i.e. annual periods beginning on or after 1 January 2019 with early application permitted. However, having a later effective date would still result in entities in jurisdictions with endorsement processes needing to change the classification for these prepayable assets when the proposed amendments become effective.

Retrospective application

Most respondents supported the proposal to require retrospective application of the amendments with the specific transitional provision – unless the second eligibility condition is removed, in which case the transitional provision is unnecessary. Some respondents that preferred a later effective date said that particular transition provisions in IFRS 9 – e.g. those related to the fair value option, applying the effective interest method, impairment and the relief from restating prior periods – should be made available again when an entity applies the amendments.

Some Board member comments on the feedback received

A Board member said that IFRS 9 was designed on the hypothesis that only particular types of instruments can be sensibly accounted for using amortised cost accounting whereas in theory all instruments can be measured at fair value through profit or loss (FVTPL). They added that the reason for including the concepts of SPPI and basic lending arrangements in IFRS 9 is that amortised cost works best for instruments with simple cash flows – e.g. those with a definite maturity and fixed/floating coupons – but not for more complex instruments. Another Board member commented that the test in IFRS 9 is whether an instrument meets the SPPI criterion and not whether it is a basic lending arrangement.

A Board member questioned whether the amendment should be an exception to the SPPI requirements and requested clarification on why these types of prepayable instruments do not meet the SPPI criterion. However, most Board members believed it is clear that these types of prepayable instruments would not meet the SPPI criterion based on the current wording in IFRS 9. Board members said that, in the interest of time and to reduce the risk of unintended consequences, the amendments should be kept very narrow and future discussions should not interpret the concept of SPPI.

The Board agreed on a project plan to re-deliberate key issues at its July meeting with a view to issuing final amendments in October 2017.

Next steps

To be in a position to issue the amendments by the end of October 2017, consistent with the project plan discussed during the Board's deliberations leading to the ED, the staff believes the Board needs to substantially complete its re-deliberations in July. To enable discussion at the July 2017 Board meeting, the staff intends to consider:

- whether the Board should proceed with the eligibility conditions as proposed in the ED or whether they should be amended;
- whether it is necessary to clarify particular aspects of the Board's conclusions and observations relating to the meaning of 'reasonable additional compensation for early termination of the contract';
- the interaction between the conditions for the proposed exception and the existing exception for certain prepayment features at par;
- whether the Board should proceed with the proposed effective date or whether a later effective date, with early application permitted, is more appropriate; and
- whether additional transition provisions and disclosure requirements are needed for entities that apply IFRS 9 before they apply the amendments.

The Board generally agreed that the above issues need to be discussed to meet the tight timeline set out in the following project plan.

Target timeline	Project plan
Board meeting in July 2017	a. Re-deliberation: technical discussions and decisions on the key issues b. Consideration of due process steps taken and permission to ballot
August and September 2017	Drafting and balloting the amendments in an expeditious manner
October 2017	Issue final amendments

KPMG insight

If the Board plans to proceed with issuing an amendment to IFRS 9 in October 2017, it will be critical to complete its technical deliberations as soon as possible. Many respondents have highlighted the urgency of the issue, in particular to avoid having to classify financial assets with prepayment features that may result in negative compensation at FVTPL when initially applying IFRS 9 and then classifying them at amortised cost or FVOCI subsequently when the amendment becomes effective. We support the speedy finalisation of these amendments.

Dynamic risk management

The story so far…

Although current IFRS – specifically, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments* – provides models for macro hedge accounting, these contain restrictions that limit companies' ability to reflect some DRM activities. Moreover, some of these models deal specifically with interest rate risk management, rather than other types of risk. Without an accounting model that reflects the broader use of DRM activities, some have asserted that it can be difficult to faithfully represent these activities in financial statements.

In April 2014, the IASB published its discussion paper *DP/2014/1 Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* (the April 2014 DP). The DP outlined one possible approach to macro hedge accounting – the portfolio revaluation approach (PRA) – under which companies' managed exposures would be identified and revalued for changes in the managed risk. As the project involves fundamental accounting questions and is not simply a modification of current hedge accounting models, the IASB did not proceed straight to issuing an ED. Our publication New on the Horizon: Accounting for dynamic risk management activities provides a detailed analysis of the proposals.

Respondents to the April 2014 DP broadly supported the macro hedging project, although several acknowledged that aligning financial reporting and DRM activities would be challenging. Despite this general support, many respondents felt that the objectives were unclear, and different stakeholder groups disagreed on what those objectives should be.

The Board decided that the project would remain as a research project, instead of being transferred to the Board's standards agenda, and that a second DP would be published before issuing an ED. Furthermore, the Board decided to keep open the possibility of moving directly to an ED if a solution emerges that addresses the disclosure, recognition and measurement issues.

In March 2017, following further research carried out, the Board reopened its discussions on the project. The staff presented an education session to the Board and outlined the project approach, project stages and next steps. In particular, the staff indicated that the focus areas for the project would include DRM activities undertaken to stabilise the net interest margin (NIM) and core deposit modelling.

At the May 2017 meeting, the staff presented another education session with the Board. More specifically, the staff outlined why and how DRM activities are undertaken to stabilise NIM, demonstrated how derivatives are used to transform portfolios when stabilising NIM and discussed NIM reconciliations.

Dynamic risk management

What's the issue?

In June 2017, the staff presented a new set of educational materials to the Board. The objectives of the session were to discuss events that result in changes to the DRM portfolio. More specifically, the staff discussed how new originations impact management's target profile for the re-pricing of loan portfolios, how DRM reacts to changes in the DRM portfolio and information relevant to financial reporting.

The Board discussed events that impact the composition of the DRM portfolio.

Changes to the DRM portfolio

The staff noted that the DRM portfolio consists of both loans (i.e. assets) and funding (i.e. liabilities such as non-interest bearing customer deposits). The DRM portfolio changes mostly because new exposures are originated or existing exposures mature.

As the DRM portfolio changes, a corresponding change can be seen in the derivative portfolio, which is used to align the loan asset profile to a target profile when stabilising NIM. In this regard, the staff noted the following main events that impact the composition of the DRM portfolio:

- product maturity;
- product growth;
- time; and
- product prepayment[1].

Product maturity

The staff noted that it is necessary to consider the maturity of existing products – i.e. loans – as part of DRM when aligning the asset profile to a target profile, and that when the asset portfolio matures as expected, there is no impact on DRM. The staff outlined that if the target profile assumes that the cash flows of a matured product will be reinvested, then the reinvested product can be aligned to the target profile with derivatives that have been priced and executed at origination.

Product growth

The staff noted that the yield on loans and the cost of funding is determined at or near origination and that growth of the asset portfolio impacts the management of interest rate re-pricing risk. The staff presented case studies to demonstrate that the asset portfolio growth can be funded by either growth in core deposits or by issued debt.

1. To be discussed in a separate Board session.

Case Study 1 – Deposit-funded growth

Consider an entity with a portfolio of five-year fixed-rate non-amortising loan assets to the value of a 1,000 with a yield of 6.5% that are funded by core deposits to the value of 1,000 with a 0% yield.

Management's target profile is for 50% of the NIM to reprice at the end of Year 3 (T3) and the remaining 50% to reprice at the end of Year 5 (T5). Management therefore executes the necessary derivative transactions to transform the portfolio such that the NIM is now 5.5%.

After a short period of time, the bank originates another 1,000 core deposits with a 0% yield. This results in the growth of available core deposits although there is no change in the target profile. Instead, the growth in core deposits increases the notional amount of the target profile – i.e. 100% of the asset portfolio is still funded by core deposits.

With the additional 1,000 core deposits, management originates new loans. DRM activities are then undertaken to assess whether the asset portfolio is aligned to the target portfolio. Additional derivatives may need to be transacted to the extent that the asset portfolio and the target portfolio are not aligned. In some instances, an examination of derivatives that have already been executed may reveal that the entity already has the necessary derivatives to align the asset and target portfolios.

Case Study 2 – Debt-funded growth

Consider the same portfolio described in Case Study 1, comprising assets that are funded by core deposits to the value of 1,000 with a 0% yield. Rather than originating additional core deposits, the entity issues 5-year fixed-rate debt and uses the cash to fund another 1,000 5-year fixed rate loans. The entity's funding mix is now 50% core deposits and 50% issued debt.

Thereafter, the target profile is updated to reflect the issued debt. In addition, the DRM activities are undertaken to align the asset and target portfolios.

In contrast to deposit-funded growth, growth funded by issued debt results in a change in NIM since issued debt has a higher yield compared to core deposits.

The staff used these case studies to explain that DRM focuses on reacting to changes in the asset portfolio and evaluating whether additional risk-mitigating actions are required. More specifically, DRM is a cycle where:

- the inputs composing the asset and target profile are updated;
- the asset and target profile are compared;
- mitigating actions are identified and taken if the relevant derivatives are not in place; and
- no further actions are required if the relevant derivatives are already in place.

Time

The staff presented another case study to demonstrate the importance of considering the effect of time when defining the target portfolio. The staff underlined the point that entities should be specific when defining the target profile taking into account how time will impact when the profile re-prices.

Information relevant to financial reporting

The staff summarised the following key points illustrated during the education session that could be considered for financial reporting.

- DRM activities are focused on aligning the asset profile to a target profile.
- An entity's funding mix – i.e. core deposits or issued debt – and management's decision regarding the NIM re-pricing profile are factors that impact the specific target profile.
- Factors such as product growth, product maturity and time affect the composition of the asset portfolio. DRM therefore involves risk-mitigating actions to react to these portfolio changes such that the asset and target portfolio remains aligned.
- The greater the specificity with which the target profile is defined, the easier it is to identify the rationale for risk-mitigating actions undertaken and the impact on NIM.

What did the IASB decide?

The Board did not make any decisions, but generally agreed with the staff's summary of events that result in a change to DRM portfolios.

Next steps

The staff indicated that the impact of product prepayments on the DRM portfolio will be discussed at a future Board meeting.

KPMG insight

The Board has discussed one type of approach to DRM that is focused on NIM management and core deposit modelling. However, entities may have other DRM approaches that employ different terminologies and practices.

For example, the case studies presented by the staff have described the target profile with reference to notional amounts, margin percentages and maturity dates. However, risk managers often express the target profile in the form of a risk limit structure with reference to market parameters – e.g. the 'PV01' measure, which expresses an entity's sensitivity to a one basis point change in interest rates, is often used by risk managers when describing a target profile across different time buckets.

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