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19 May 2017

By email: commentletters@hkicpa.org.hk and by post

Ms. Eky Liu
Standard Setting Department
Hong Kong Institute of Certified Public Accountants
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Dear Eky

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

Thank you for your letter dated 27 April 2017 inviting our comments on the captioned IASB exposure draft. Our comments on the specific questions raised in the exposure draft are set out in the enclosed annex for your consideration.

Should you have any questions, please contact our Manager Ms Emily Ngan at 2526 6080 or our Officer Ms Melissa Law at 2567 1780.

Yours sincerely

Celia Shing
Secretary

Enc.

Chairman Bank of China (Hong Kong) Limited
Vice Chairman The Hongkong and Shanghai Banking Corporation Limited
Standard Chartered Bank (Hong Kong) Limited
Secretary Celia Shing

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副主席 香港上海滙豐銀行有限公司
渣打銀行（香港）有限公司
秘書 盛思怡

Incorporated by Ordinance, Cap. 364
根據條例第364章成立

Annex

HKAB Comments on Consultation on Prepayment Features with Negative Compensation – Proposed Amendments to IFRS 9

Q1. 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?

We agree that the concerns raised relating to prepayment features with negative compensation should be addressed. It is a pervasive market practice in Hong Kong that loans contain prepayment features with negative compensation. We agree with the observation made by the Board that these are regarded as relatively simple and 'plain vanilla' instruments, as described in paragraph BC16 of the Exposure Draft. However, the prepayment option may affect the contractual cash flows and may consequently cause the debt instrument to fail the contractual cash flow test at initial recognition, thereby causing the instrument to be measured at fair value through profit or loss which would not provide more meaningful or useful information than amortised cost or FVOCI.

Q2. 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?

We agree with the first criterion. As long as the compensation is reasonable, the prepayment feature alone should not fail the SPPI test in both positive and negative compensation situations.

We disagree with the second criterion. The reason given for having the second criterion in paragraph BC21 was to minimise the occurrence of adjustments described in paragraph B5.4.6 ("B5.4.6 adjustments"). We note that even without the prepayment feature, in applying the

effective interest method, there could be multiple B5.4.6 adjustments over the course of a loan's life. In particular, for products with stepped interest rate features or where changes in actuarial life assumptions impact the period over which the loan is amortised.

We further note that paragraph B4.1.11(b) of IFRS 9 already addresses the situation where loan products have prepayment options. In particular, it notes that if the compensation element is reasonable, this will be sufficient to meet the SPPI test. We believe that all contingent features should be assessed consistently, and accordingly this proposed amendment would result in inconsistency in treatment and would propose removing this criterion.

In order to further assess this, we request further clarification on the interpretation of paragraph BC18 (financial assets that are prepayable at an amount that includes the fair value of an associated hedging instrument). This paragraph applies to situations when a hedge unwind cost (either at a loss or profit to the lender) would need to be excluded from the SPPI test. However, it is unclear how this would be applied in for products that include two-way hedge unwind cost clauses[1] that are common in Hong Kong.

Q3. For the reasons set out in paragraph 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?

We agree with the proposed effective date.

[1] Two-way hedges refer to those situations where the gains or losses associated with the unwinding of a hedging instrument (e.g. an interest rate swap hedging the interest rate risk on a loan) is passed on to the borrower. The unwinding event may be triggered by a prepayment in the underlying loan.

Annex

Q4. 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 paragraph 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?

(a) We agree with the application of the transition provision.

(b) We have no further comment on transition considerations that need to be specifically addressed for entities.