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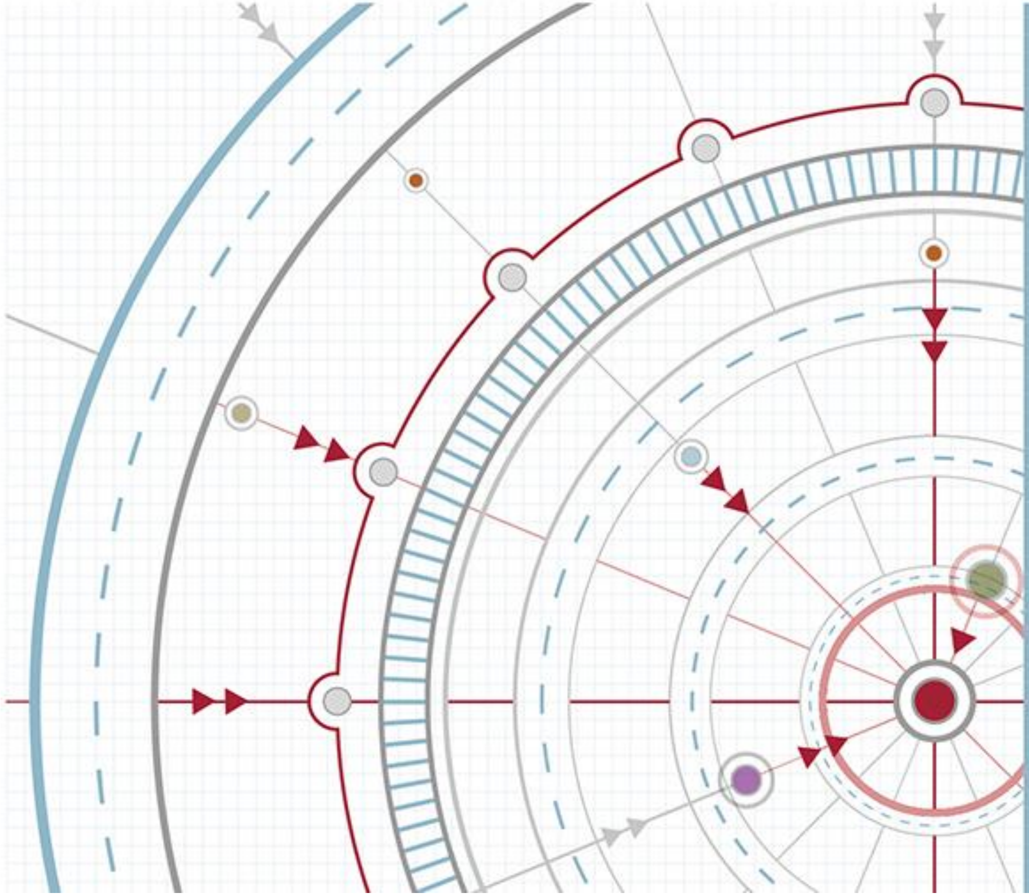

IFRS 9 *Financial Instruments*

Prepayment features

June 2018

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Objective of this webcast

- Discuss how to apply the ‘SPPI test’ in IFRS 9 to prepayable financial assets by highlighting the relevant requirements in IFRS 9

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Relevant requirements in IFRS 9

General requirements

Applying IFRS 9, financial assets are subsequently measured at amortised cost (AC), fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVPL) on the basis of both:

The contractual cash flow characteristics of the financial asset

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The entity's business model for managing the financial assets

To be eligible for measurement at AC or FVOCI, an asset's contractual cash flows must be solely payments of principal and interest (ie the asset meets the 'SPPI test')

The business model test is outside the scope of this webcast.

[Extracted from paragraphs 4.1.1 - 4.1.2A]

Specific requirements

Some prepayable financial assets meet the SPPI test and thus are eligible to be measured at AC or FVOCI.

Specifically, a prepayment feature meets the SPPI test if…

…the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable compensation for the early termination of the contract.

[Extracted from paragraph B4.1.11(b)]

Narrow exception

There is a narrow exception for particular financial assets that do not meet the SPPI test only as a result of a contractual prepayment feature.

Specifically, such a prepayable financial asset is eligible to be measured at AC or FVOCI if three conditions are met:

1. the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
2. the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for the early termination of the contract; and
3. when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

[Extracted from paragraph B4.1.12]

Some views on this topic

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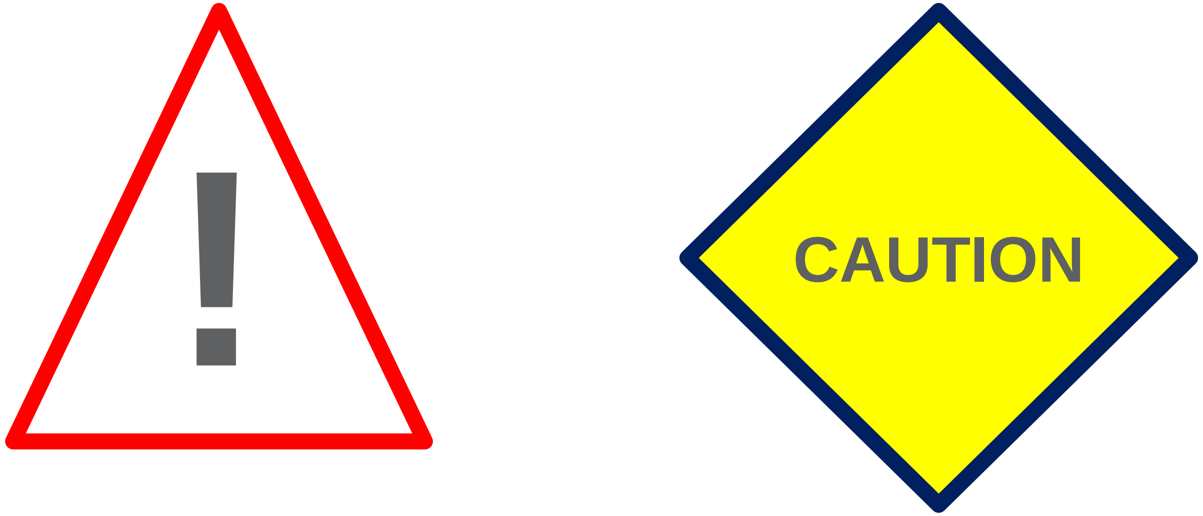
Some have suggested that a prepayment feature will meet the SPPI test (ie without further analysis) when the prepayment amount, or specifically the 'compensation' that is included in that prepayment amount:

- …is agreed by both parties
- …reflects 'market practice'
- …is labelled as 'make whole'
- …is unlikely to be triggered (ie prepayment is unlikely)
- …is computed using a 'market rate'

In other words, some have suggested that if one or more of these factors is present, then the prepayment feature meets the SPPI test without further analysis.

What does IFRS 9 say?



The factors on slide 8 are not determinative, individually or collectively, without further analysis.

Summary

- A prepayment feature must be analysed to determine whether it gives rise to contractual cash flows that meet the SPPI test.

- In order to be eligible for measurement at AC or FVOCI, a prepayable financial asset must meet either the requirements in paragraph B4.1.11(b) or all of the conditions for the exception in paragraph B4.1.12.

- It is inconsistent with the requirements in IFRS 9 to conclude (ie without further analysis) that a prepayment feature meets the SPPI test merely because one or more of the factors on slide 8 is present.

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