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Exposure Draft ED/2017/3

Prepayment Features with Negative Compensation

Proposed amendments to IFRS 9

Comments to be received by 24 May 2017

IASB[®]

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Prepayment Features with Negative Compensation

(Proposed amendments to IFRS 9)

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Introduction

This Exposure Draft, published by the International Accounting Standards Board (the Board), proposes amendments to IFRS 9 *Financial Instruments*. These amendments are designed to address the concerns of some interested parties about how IFRS 9 classifies particular prepayable financial assets.

In July 2014, the Board issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for annual periods beginning on or after 1 January 2018 with early application permitted.

After IFRS 9 was issued, the IFRS Interpretations Committee (the Interpretations Committee) received a submission asking how to classify particular prepayable financial assets applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower to prepay the instrument at a variable amount that could be more or less than unpaid amounts of principal and interest, such as at the instrument's current fair value or at an amount that reflects the remaining contractual cash flows discounted at the current market interest rate. As a result of such a contractual prepayment feature, the lender could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. Such a prepayment amount would, in effect, include an amount that reflects a payment **to** the borrower by the lender (instead of compensation **from** the borrower to the lender) even though the borrower chose to terminate the contract early. Applying IFRS 9, those contractual cash flows are not solely payments of principal and interest, and therefore the financial assets would be measured at fair value through profit or loss. However, Interpretations Committee members suggested that the Board consider whether using amortised cost measurement could provide useful information about particular financial assets with such prepayment features, and if so, whether the requirements in IFRS 9 should be changed in this respect.

In the light of the Interpretations Committee's recommendation and similar concerns raised by banks and their representative bodies in response to the Interpretations Committee's discussion, the Board decided to propose 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. Applying the proposals, some such financial assets 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 they are held, if particular conditions are met.

The IASB and IFRS Interpretations Committee's *Due Process Handbook* permits a comment period of less than the standard minimum period of 120 days if the matter is narrow in scope and urgent. The Board believes that the proposals in the Exposure Draft are both narrow in scope (because they affect only those entities that hold particular prepayable financial assets) and urgent (because there would be significant benefits if any amendments to IFRS 9 resulting from these proposals were finalised before the effective date of IFRS 9).

Consequently, with approval from the Due Process Oversight Committee, the Board has set a comment period for the Exposure Draft of 30 days.

Next steps

The Board will consider the comments that it receives on the proposals and will decide whether to proceed with the proposed amendments to IFRS 9. The Board intends to complete any resulting amendments to IFRS 9 as soon as possible in 2017.

Invitation to comment

The Board invites comments on the proposals in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

- (a) comment on the questions as stated;
- (b) indicate the specific paragraph(s) to which they relate;
- (c) contain a clear rationale; and
- (d) describe any alternative that the Board should consider, if applicable.

The Board is requesting comments only on matters that are addressed in this Exposure Draft.

Comments should be submitted in writing to be received no later than **24 May 2017**.

Questions for respondents

Question 1—Addressing the concerns raised
<p>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.</p> <p>Do you agree that the Board should seek to address these concerns? Why or why not?</p>

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?

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 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?

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 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?

How to comment

Comments should be submitted using one of the following methods.

Electronically Visit the 'Comment on a proposal' page, which can be found at:
(our preferred method) go.ifrs.org/comment

Email Email comments can be sent to: commentletters@ifrs.org

Postal IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

All comments will be on the public record and posted on our website unless confidentiality is requested. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and how we use your personal data.

[Draft] Amendments to IFRS 9 *Financial Instruments*

Paragraphs 7.1.7 and 7.2.5A are added. New text is underlined.

Chapter 7 Effective date and transition

7.1 Effective date

...

7.1.7 [Draft] *Prepayment Features with Negative Compensation (Amendments to IFRS 9)*, issued in [date], added paragraphs 7.2.5A and B4.1.12A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

7.2 Transition

...

Transition for classification and measurement (Chapters 4 and 5)

...

7.2.5A If, at the date of initial application (or at the date that an entity first applies paragraph B4.1.12A, if later), it is impracticable (as defined in IAS 8) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph B4.1.12A(b) on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12A. (See also paragraph 42T of IFRS 7.)

In Appendix B, paragraph B4.1.12A is added. Paragraphs B4.1.10, B4.1.11 and B4.1.12 have not been amended but have been included for ease of reference. New text is underlined.

Classification (Chapter 4)

Classification of financial assets (Section 4.1)

...

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

...

Contractual terms that change the timing or amount of contractual cash flows

- B4.1.10 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator. For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding because of the relationship between missed payments and an increase in credit risk. (See also paragraph B4.1.18.)
- B4.1.11 The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:
- (a) a variable interest rate that consists of consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin;

- (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and
- (c) a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument (ie an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract.

B4.1.12 Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:

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

B4.1.12A Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:

- (a) the prepayment amount is inconsistent with paragraph B4.1.11(b) 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.

[Draft] amendments to other Standards

The Board expects to make the amendments described below if it finalises the proposed amendments to IFRS 9.

Standard	Description of amendment
IFRS 7 <i>Financial Instruments: Disclosures</i>	<p>An additional disclosure requirement will be added to IFRS 7 as follows:</p> <p>42T In accordance with paragraph 7.2.5A of IFRS 9, if it is impracticable (as defined in IAS 8) at the date of initial application (or at the date that an entity first applies paragraph B4.1.12A, if later) for an entity to assess whether the fair value of a prepayment feature was insignificant in accordance with paragraph B4.1.12A(b) of IFRS 9 based on the facts and circumstances that existed at the initial recognition of the financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12A of IFRS 9. An entity shall disclose the carrying amount at the reporting date of the financial assets whose contractual cash flow characteristics have been assessed based on the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the exception for prepayment features in paragraph B4.1.12A of IFRS 9 until those financial assets are derecognised.</p>
IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i>	<p>A paragraph will be added to IFRS 1 as follows:</p> <p>B8BA If it is impracticable to assess whether the fair value of a prepayment feature is insignificant in accordance with paragraph B4.1.12A(b) of IFRS 9 on the basis of the facts and circumstances that exist at the date of transition to IFRS Standards, an entity shall assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the date of transition to IFRS Standards without taking into account the exception for prepayment features in paragraph B4.1.12A of IFRS 9. (In this case, the entity shall also apply paragraph 42T of IFRS 7 but references to 'paragraph 7.2.5A of IFRS 9' shall be read to mean this paragraph and references to 'initial recognition of the financial asset' shall be read to mean 'at the date of transition to IFRS Standards'.)</p>

Approval by the Board of *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) published in April 2017

The Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) was approved for publication by 11 of 13 members of the International Accounting Standards Board. Mr Kabureck voted against its publication. His alternative view is set out after the Basis for Conclusions on the Exposure Draft. Mr Thomas Scott abstained in view of his recent appointment to the Board.

Hans Hoogervorst Chairman

Suzanne Lloyd Vice-Chair

Stephen Cooper

Martin Edelmann

Françoise Flores

Amaro Luiz de Oliveira Gomes

Gary Kabureck

Takatsugu Ochi

Darrel Scott

Thomas Scott

Chungwoo Suh

Mary Tokar

Wei-Guo Zhang

Basis for Conclusions on the Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9)

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Background

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) when developing the amendments proposed in the Exposure Draft *Prepayment Features with Negative Compensation*. Individual IASB members gave greater weight to some factors than to others.
- BC2 In July 2014, the IASB issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for annual periods beginning on or after 1 January 2018 with early application permitted.
- BC3 After IFRS 9 was issued, the IFRS Interpretations Committee (the Interpretations Committee) received a submission asking how particular prepayable financial assets would be classified applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower to prepay the instrument at a variable amount that could be more or less than unpaid amounts of principal and interest, such as the instrument's current fair value or an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate.
- BC4 Paragraph B4.1.11(b) of IFRS 9 sets out how the requirements in paragraph B4.1.10 of that IFRS apply to contractual terms that permit the early termination of a contract and, specifically, describes those that result in contractual cash flows that are solely payments of principal and interest. Paragraph B4.1.11(b) states that a contractual term that permits the issuer (ie the borrower) to prepay a debt instrument, or permits the holder (ie the lender) to put a debt instrument back to the issuer before maturity, results in contractual cash flows that are solely payments of principal and interest only if the prepayment amount substantially represents unpaid amounts of principal and interest, which may include reasonable additional compensation for the early termination of the contract. Accordingly, that paragraph explains that a prepayable financial asset may be eligible to be measured at amortised cost or fair value through other comprehensive income if the party choosing to exercise its option to terminate the contract compensates (ie pays a prepayment penalty to) the party that must accept that choice.
- BC5 However, the prepayment options described in the submission to the Interpretations Committee could force the lender to accept a prepayment amount that, in effect, includes an amount that reflects a payment *to* the borrower, instead of compensation *from* the borrower, even though the borrower chose to prepay the debt instrument. An outcome in which the party choosing to terminate the contract *receives* an amount (instead of *pays* an amount) is

inconsistent with paragraph B4.1.11(b) of IFRS 9. Specifically, it is inconsistent with the notion of ‘reasonable additional *compensation* for the early termination of the contract’ as that notion is used in IFRS 9 and, in this Basis for Conclusions, such an outcome is referred to as ‘negative compensation’. Thus, the instruments described in the submission do not have contractual cash flows that are solely payments of principal and interest and those instruments would be measured at fair value through profit or loss applying IFRS 9.

- BC6 Nevertheless, Interpretations Committee members suggested that the IASB consider whether amortised cost measurement¹ could provide useful information about particular financial assets with prepayment features that may result in ‘negative compensation’, and if so, whether the requirements in IFRS 9 should be changed in this respect. However, the Interpretations Committee acknowledged that amortised cost measurement would not be appropriate for all such prepayable financial assets and it could be difficult to define the relevant population.

Proposed amendments to IFRS 9 for particular prepayment features

- BC7 In the light of the Interpretations Committee’s recommendation and similar concerns raised by banks and their representative bodies in response to the Interpretations Committee’s discussion, the IASB decided to propose a narrow exception to the requirements in IFRS 9 for the classification and measurement of financial assets. This exception would apply to particular prepayable financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 but do not meet that condition only as a result of the prepayment feature. Specifically, this Exposure Draft proposes that such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are 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 (paragraphs BC9–BC19); and
 - (b) the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset (paragraphs BC20–BC24).

¹ In this Basis for Conclusions, the discussion of amortised cost measurement is relevant to both the amortised cost measurement category and the fair value through other comprehensive income measurement category. That is because, for the latter, the assets are measured at fair value in the statement of financial position and amortised cost information is provided in profit or loss. A financial asset is measured at amortised cost or fair value through other comprehensive income only if both conditions in paragraph 4.1.2 or paragraph 4.1.2A, respectively, are met. The exception proposed in the Exposure Draft addresses only the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Accordingly, this Basis for Conclusion does not discuss the conditions in paragraphs 4.1.2(a) and 4.1.2A(a) relating to the business model but instead assumes that the asset is held in the relevant business model.

BC8 The IASB has said that it will be responsive to issues that are identified during the implementation of IFRS 9 and the proposals in this Exposure Draft are consistent with that commitment. However, the IASB acknowledges that the proposed exception adds complexity to IFRS 9 and, given the impending effective date of IFRS 9, could disrupt some entities' implementation activities. Accordingly, the proposed eligibility conditions are intended to ensure that the scope of the exception is narrow and targets a specific population of prepayable financial assets for which amortised cost could provide useful information to users of financial statements. The IASB notes that such a precise scope is necessary so that the principles for classifying and measuring financial assets, which were carefully deliberated during the development of IFRS 9, remain intact and clear. In addition, the narrow scope facilitates the timely completion of any amendments given the proximity to the effective date of IFRS 9.

The first eligibility condition—the prepayment amount

BC9 The IASB's view, which underpins the classification and measurement requirements in IFRS 9, is that amortised cost provides useful information about particular financial assets in particular circumstances. That is because, for those assets in those circumstances, amortised cost provides information that reflects the amount, timing and uncertainty of future cash flows. Amortised cost is calculated using the effective interest method, which is a relatively simple measurement technique that allocates interest over the relevant time period using the effective interest rate.

BC10 The objective of the requirements in IFRS 9 to assess an asset's contractual cash flows is to identify instruments for which the effective interest method results in useful information. As stated in the Basis for Conclusions on IFRS 9, the IASB believes that the effective interest method is suitable only for instruments with simple cash flows that represent principal and interest. More complex cash flows require a valuation overlay to contractual cash flows (ie fair value) so that the reported financial information is useful to users of financial statements.

BC11 In developing the proposals in this Exposure Draft, the IASB noted that it is critical to maintain the principle described in paragraphs BC9–BC10. Therefore, any proposal to measure at amortised cost financial assets with prepayment features that may result in 'negative compensation' must be limited to those for which the effective interest method provides useful information to users of financial statements. Accordingly, the first eligibility condition (set out in paragraph B4.1.12A(a) of the Exposure Draft) aims to identify prepayment features that do not introduce any contractual cash flow amounts that are different from the cash flow amounts that are accommodated by paragraph B4.1.11(b) of IFRS 9.

BC12 The IASB noted that paragraph B4.1.11(b) of IFRS 9 accommodates contractual terms that permit either the borrower *or* the lender to choose to terminate the contract early and compensate the other party for having to accept that choice. In other words, that paragraph permits the following:

- (a) if the *borrower* chooses to terminate the contract early, then the borrower may be required to compensate the lender for having to accept that choice and, as a result, the prepayment amount may be *more than* unpaid amounts of principal and interest; and
- (b) if the *lender* chooses to terminate the contract early, then the lender may be required to compensate the borrower for having to accept that choice and, as a result, the prepayment amount may be *less than* unpaid amounts of principal and interest.

BC13 Accordingly, the existing notion of reasonable additional compensation for the early termination of the contract in paragraph B4.1.11(b) of IFRS 9 accommodates a prepayment amount that is more or less than unpaid amounts of principal and interest, depending on which party chooses to terminate the contract early. In applying the effective interest method to measure such financial assets at amortised cost at initial recognition, the entity would consider the contractual cash flows arising from such a prepayment feature when it estimates the future cash flows and determines the effective interest rate. Subsequently, consistent with the treatment of all financial assets measured at amortised cost, the entity would apply paragraph B5.4.6 of IFRS 9 and make a catch-up adjustment to adjust the gross carrying amount of the financial asset if it revises its estimates of contractual cash flows, including any revisions related to the exercise of the prepayment feature.

BC14 Similarly, for a financial asset with a prepayment feature that may result in 'negative compensation', the prepayment amount may be more or less than unpaid amounts of principal and interest. However, as discussed above, the difference is that such a prepayment feature could have the result that the party that triggers the early termination of the contract may, in effect, receive an amount *from* the other party, rather than pay compensation *to* the other party. To illustrate that difference, the IASB considered the following two instruments during the development of the proposals in this Exposure Draft:

- (a) Asset A is a prepayable financial asset whose contractual features are consistent with paragraph B4.1.11(b) of IFRS 9. Specifically, both the borrower and the lender have the option to terminate Asset A before maturity. The party that exercises its option must compensate the other party for the effect of the change in the relevant market interest rate since Asset A was initially recognised. Accordingly, if the borrower decides to prepay Asset A and the relevant market interest rate has decreased, then the borrower must compensate the lender for the present value of lost interest revenue. This amount will compensate the lender for receiving a lower return if it reinvests in a similar contract for Asset A's remaining contractual term. If the borrower decides to prepay and the relevant market interest rate has increased (or stayed the same), then there is no additional compensation due. Correspondingly, if the lender decides to put Asset A back to the borrower and the relevant market interest rate has increased, then the lender must compensate the borrower for the effect of that change. This amount will compensate the borrower for having to pay a higher rate if it enters into a similar arrangement for Asset A's remaining contractual term. If the lender

decides to terminate early and the relevant market interest rate has decreased (or stayed the same), then there is no additional compensation due.

- (b) Asset B is the same as Asset A except that the prepayment feature may result in ‘negative compensation’ and therefore the IASB concluded that it is inconsistent with paragraph B4.1.11(b) of IFRS 9. Specifically, the additional ‘compensation’ amount does not depend on which party chooses to terminate Asset B early but instead depends only on the movement in the relevant market interest rate. As a result, the borrower or the lender may receive an amount even if it is the party that chooses to exercise its option to terminate the contract early. That is, if Asset B is terminated early (by *either* party) and the relevant market interest rate has decreased since Asset B was initially recognised, then the lender will effectively receive an amount representing the present value of lost interest revenue over Asset B’s remaining term. Correspondingly, if the contract is terminated early (by *either* party) and the relevant market interest rate has increased, the borrower will effectively receive an amount that represents the effect of that change in that interest rate over Asset B’s remaining term.

BC15 Asset B does not introduce any contractual cash flow amounts that are different from the cash flow amounts that may arise from Asset A because, in all cases, the prepayment amount reflects unpaid amounts of principal and interest plus (or minus) an amount to reflect the effect of the change in the relevant market interest rate. However, Asset B changes the *circumstances* in which the ‘compensation’ amounts could arise. That is, Asset B may result in either reasonable additional compensation or reasonable ‘negative compensation’, for the early termination of the contract. As a result, applying amortised cost, it is more likely that the lender will be required to make catch-up adjustments to reflect revisions to its estimates of contractual cash flows, including adjustments to reflect circumstances in which the lender is forced to settle the contract in a way that it would not recover its investment. The IASB noted that such adjustments in the gross carrying amount could reduce the usefulness of amortised cost measurement, which otherwise simply uses the effective interest method to allocate interest over the relevant time period. These catch-up adjustments are discussed further in paragraph BC21.

BC16 The IASB understands that the objective of a prepayment feature such as the one described in Asset B is to ensure that each party is ‘made whole’. That is, despite the early termination of the contract, the lender ultimately would receive, and the borrower ultimately would pay, the initially agreed upon contractual rate for Asset B if the parties enter into new arrangements similar to Asset B for Asset B’s remaining term. Interested parties have told the IASB that such prepayment features are prevalent in particular types of otherwise ‘plain vanilla’ lending instruments, such as corporate loans and retail mortgages, and that measuring such assets at amortised cost, and including them in key metrics like net interest margin, would provide the most useful information to users of financial statements about the financial assets’ performance. The IASB acknowledges these views.

- BC17 The IASB thinks that, from a computation perspective, the effective interest method, and thus amortised cost measurement, could be applied to the contractual cash flows that arise from prepayable financial assets like Asset B. In addition, the IASB thinks that amortised cost measurement could provide useful information to users of financial statements about financial assets whose prepayment amount is consistent with paragraph B4.1.11(b) *in all respects* except that 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. As discussed above, such prepayment features do not introduce any contractual cash flow amounts that are different from the cash flow amounts that are accommodated by paragraph B4.1.11(b) of IFRS 9. Therefore, the proposed condition in paragraph B4.1.12A(a) of this Exposure Draft captures those prepayment features that would have been accommodated by paragraph B4.1.11(b) *except* for the fact that a party may receive such an amount even if it is the party that chooses to terminate the contract early (or otherwise causes the early termination to occur).
- BC18 However, the IASB notes that the effective interest method, and thus amortised cost measurement, are not appropriate when the prepayment amount is inconsistent with paragraph B4.1.11(b) for any reason other than that described in paragraph BC7(a). For example, the IASB is aware that some financial assets are prepayable at their current fair value and some interested parties have expressed the view that those prepayable financial assets should be eligible for amortised cost measurement. The IASB concluded that such a prepayment amount is inconsistent with paragraph B4.1.11(b) not only because it may result in ‘negative compensation’ but also because the amount exposes the holder to changes in the fair value of the instrument, and contractual cash flows resulting from such exposure are not solely payments of principal and interest. The Board concluded that a fair value amount is not reasonable compensation *for the early termination of the contract*. Accordingly, the IASB thinks amortised cost measurement does not provide useful information about a financial asset prepayable at its current fair value and therefore such a financial asset would not meet the condition proposed in paragraph B4.1.12A(a) of the Exposure Draft. Instead the instrument would be measured at fair value through profit or loss. The IASB noted that this outcome is consistent with the overall structure of IFRS 9 that measures a financial asset at amortised cost only if its contractual terms give rise to simple cash flows and the asset is held in a business model in which collecting those contractual cash flows is integral to its objective. If the financial asset has cash flows that are more complex than solely payments of principal and interest, or if the asset is held in a business model with an objective to realise the asset’s fair value through sale, then the Board concluded that amortised cost does not provide useful information. 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 if that prepayment amount is inconsistent with paragraph B4.1.11(b) because the amount exposes the holder to factors that could result in contractual cash flows that are not solely payments of principal and interest.
- BC19 The Board also observes that a financial asset cannot meet the conditions for the exception set out in paragraph B4.1.12 of IFRS 9 *and* the conditions for the

exception proposed in paragraph B4.1.12A of the Exposure Draft. The conditions for those exceptions are mutually exclusive. That is because the prepayment amount described in paragraph B4.1.12(b) is different from the prepayment amount described in paragraph B4.1.12A(a). Specifically, paragraph B4.1.12 applies when an entity acquires or originates a financial asset at a premium or discount to the contractual par amount—ie the principal amount is more than (in the case of a premium) or less than (in the case of a discount) the par amount—but the financial asset can be prepaid at the par amount plus any accrued (but unpaid) contractual interest. That prepayment amount would not meet the condition proposed in paragraph B4.1.12A(a) because it is inconsistent with paragraph B4.1.11(b) for a reason *other than* it may result in ‘negative compensation’. That is, the prepayment amount described in paragraph B4.1.12(b) represents the *contractual par amount* and accrued (but unpaid) *contractual interest* rather than unpaid amounts of *principal and interest*. Accordingly, for example, if a financial asset is acquired at a significant discount to the contractual par amount—ie the principal amount is significantly less than the par amount—but the asset can be prepaid at any time at the contractual par amount plus accrued (but unpaid) contractual interest *and* that prepayment amount may include ‘negative compensation’, then that financial asset would be measured at fair value through profit or loss.

The second eligibility condition—the fair value of the prepayment feature

- BC20 Although the IASB thinks that the effective interest method could be applied to some financial assets with prepayment features that may result in ‘negative compensation’, the IASB concluded that measuring such prepayable financial assets at amortised cost would be an exception to the classification and measurement requirements in IFRS 9. Such contractual prepayment features are inconsistent with a basic lending arrangement. That is because the lender could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest, with the result that it would not recover its investment for reasons other than the asset’s credit quality. Similarly, the borrower could be forced to repay an amount to the lender that is substantially more than the unpaid amounts of principal and interest that it owes.
- BC21 Moreover, as described in paragraph BC15, although prepayable financial assets that meet the condition proposed in paragraph B4.1.12A(a) of the Exposure Draft do not introduce any contractual cash flow amounts that are different to the cash flow amounts that are currently accommodated by paragraph B4.1.11(b) of IFRS 9, such assets do change the *circumstances*, or more specifically they *increase the frequency*, in which the contractual ‘compensation’ amounts could arise. Accordingly, the likelihood is higher that the lender will be required to make catch-up adjustments applying paragraph B5.4.6 of IFRS 9 to reflect revisions to its estimates of contractual cash flows related to the exercise of the prepayment feature. Although the IASB acknowledges that such adjustments are already required for all financial instruments measured at amortised cost, including those assets described in paragraph B4.1.11(b) of IFRS 9, the IASB thinks that it would be inappropriate if the proposed exception significantly increased the

frequency of such adjustments. That is because recognising frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the objective of the effective interest method, which is a relatively simple measurement technique that allocates interest using the effective interest rate over the relevant time period. Recognising more frequent adjustments in the gross carrying amount could reduce the usefulness of the interest amounts that are calculated using such a simple measurement technique and thus could suggest that fair value measurement would provide more useful information.

- BC22 Accordingly, the IASB proposes a second eligibility condition so that the scope of the proposed exception is sufficiently narrow and that amortised cost measurement is not extended beyond the population of financial assets for which the effective interest method can provide useful information. To achieve that objective, the condition proposed in paragraph B4.1.12A(b) of this Exposure Draft would require that, to be eligible for the exception, the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. The IASB thinks that this condition is a straightforward way to limit the scope of the proposed exception so that financial assets are eligible to be measured at amortised cost only if it is unlikely that prepayment (and thus, the ‘negative compensation’) will occur.
- BC23 If a financial asset is prepayable at its current fair value, then it is likely that the prepayment feature has an insignificant fair value, irrespective of the probability of prepayment. However, as discussed in paragraph BC18, that prepayment amount would not meet the condition proposed in paragraph B4.1.12A(a) of the Exposure Draft because a fair value amount is not reasonable compensation for the early termination of the contract. Since the exception proposed in the Exposure Draft would apply only to those prepayable financial assets that meet both conditions, it would not apply to a financial asset that is prepayable at its current fair value. That financial asset would be measured at fair value through profit or loss.
- BC24 Some interested parties have expressed the view that if a prepayment feature compensates the parties to the contract only for changes in the relevant market interest rate (eg the prepayment features described in Asset A and Asset B in paragraph BC14), then that prepayment feature would also have an insignificant fair value, irrespective of the probability of prepayment. However, the IASB noted that such a prepayment amount is different from a prepayment amount equal to the instrument’s current fair value (discussed above in paragraph BC23) because it reflects compensation for the change in only part of the interest rate (eg for a change in the benchmark rate) but not the change in other drivers of fair value. Consequently, such a prepayment feature could have a fair value that is more than insignificant unless it is unlikely that prepayment will occur.

Effective date

- BC25 The Exposure Draft proposes that the effective date of the amendments is the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018. An entity would be permitted to apply the amendments early if

it applies IFRS 9 early. The IASB thinks there would be significant benefits if entities initially apply IFRS 9 taking into account the effect of the proposed exception. Specifically, the IASB thinks that it would be inefficient and burdensome for entities to initially apply IFRS 9 without this exception and then be required to change the classification and measurement of some prepayable financial assets when they apply the exception at a later date. Similarly, this would be disruptive for users of financial statements.

- BC26 However, the IASB acknowledges that many entities are advanced in their implementation of IFRS 9 and may not have sufficient time before the effective date of IFRS 9 to determine the effect of these amendments. Additionally, the IASB is aware that some jurisdictions will need time for translation and endorsement activities and the proposed effective date may not provide sufficient time. Therefore, the IASB is asking for feedback on whether a later effective date, with early application permitted, would be more appropriate.

Transition

- BC27 Consistent with the existing transition requirements in IFRS 9 for assessing whether the contractual terms of a financial asset give rise to cash flows that are solely payments of principal and interest, the Exposure Draft proposes that the amendments be applied retrospectively. Accordingly, an entity would need to determine whether a prepayable financial asset meets the conditions set out in paragraph B4.1.12A of this Exposure Draft, including whether the fair value of the prepayment feature was insignificant, on the basis of the facts and circumstances that existed at the initial recognition of the financial asset.
- BC28 The IASB thinks entities will have the required fair value information in most cases because that information is required to apply the embedded derivative requirements in IAS 39. However, it may be impracticable for an entity to determine whether the fair value of the prepayment feature was insignificant at the date of initial recognition if it had previously designated the financial asset under the fair value option applying IAS 39. Accordingly, the Exposure Draft proposes that if it is impracticable for an entity to make that determination on the basis of the facts and circumstances that existed at the initial recognition of the asset, then the entity must assess the contractual cash flow characteristics of the financial asset without taking into account the proposed exception set out in this Exposure Draft. This proposal is similar to the existing transition provisions in IFRS 9 for assessing some other contractual features (see paragraphs 7.2.4 and 7.2.5 of IFRS 9).
- BC29 The Exposure Draft proposes that an additional disclosure requirement is added to IFRS 7 *Financial Instruments: Disclosures* for circumstances in which an entity applies the transition provision described in paragraph BC28 (and thus assesses the contractual cash flows *without taking into account* the proposed exception). In such circumstances, the entity would disclose the carrying amount of those financial assets until they are derecognised. The same disclosure requirement accompanies the existing transition provisions in IFRS 9 for assessing some other contractual features (see paragraphs 42R–42S of IFRS 7). The IASB thinks that this disclosure would provide useful information about how an entity

assessed the contractual cash flow characteristics of particular financial assets on transition to IFRS 9—ie whether the entity applied the exception in the Exposure Draft when it assessed the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9—and therefore enhances comparability both between different entities and for a single entity over time.

Entities that apply IFRS 9 before they apply the amendments

- BC30 As described in paragraph BC25, the Exposure Draft proposes that the effective date of the amendments is the same as the effective date of IFRS 9. As a result, most entities would initially apply IFRS 9 taking into account the effect of the proposed exception. These entities would apply all of the transition provisions and relief in Section 7.2 of IFRS 9 at the same time, including the provision proposed in paragraph 7.2.5A of the Exposure Draft.
- BC31 However, some entities have already early applied IFRS 9 and therefore would apply the proposed amendments separately from (ie subsequent to) the initial application of IFRS 9. These entities would apply the exception retrospectively, subject to the requirements for changes in accounting policies in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* and the provision proposed in paragraph 7.2.5A of the Exposure Draft. The other transition provisions and relief in Section 7.2 of IFRS 9 would not be applicable when the entity applies the amendments. That is because, as set out in paragraph 7.2.27 of IFRS 9, an entity applies each of the transition requirements in IFRS 9 only once. The IASB is asking for feedback on whether there are additional transition considerations specific to entities that would apply the proposed amendments after they apply IFRS 9. If the effective date of the amendments is later than the effective date of IFRS 9, as discussed in paragraph BC26, then such additional transition provisions would be relevant to a larger population.

First-time adopters of IFRS

- BC32 The proposed transition provision and disclosure discussed in paragraphs BC27–BC29 are also relevant for first-time adopters of IFRS. Therefore, corresponding amendments are proposed to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Those proposals are similar to the existing requirements in IFRS 1 for assessing some other contractual features (see paragraphs B8A–B8B of IFRS 1).

Alternative view

Alternative view on the Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) as published in April 2017

- AV1 Mr Kabureck voted against the publication of the Exposure Draft. While he fully agrees that the IASB needs to be responsive to issues that are raised during the implementation of IFRS 9, Mr Kabureck believes that there is not a compelling reason to amend IFRS 9 as proposed in the Exposure Draft. Specifically, he believes that:
- (a) the relevant requirements in IFRS 9 are clear and measuring financial assets with prepayment features that may result in 'negative compensation' at fair value through profit or loss is appropriate;
 - (b) the issue addressed by the Exposure Draft is not sufficiently broad to justify an amendment; and
 - (c) there was ample time during the development of IFRS 9 for this issue to be raised but the concern did not arise during any stage of the IASB's due process and a compelling case has not been made to amend IFRS 9 so close to its effective date.
- AV2 In Mr Kabureck's view, the relevant accounting requirements in IFRS 9 are straightforward and appropriate. Applying IFRS 9, some financial assets with prepayment features that may result in reasonable additional compensation are eligible to be measured at amortised cost (or at fair value through other comprehensive income, which provides amortised cost information in profit or loss) but financial assets with prepayment features that may result in 'negative compensation' must be measured at fair value through profit or loss. Mr Kabureck notes that those outcomes are consistent with a basic lending arrangement, as that notion is used in IFRS 9 to underpin the assessment of a financial asset's contractual cash flows, because a financial asset is not measured at amortised cost if the lender can be forced to accept a prepayment amount that is less than unpaid amounts of principal and interest. In contrast, the Exposure Draft proposes that some financial assets with prepayment features that may result in 'negative compensation' would be eligible to be measured at amortised cost. Mr Kabureck observes that such a proposal is inconsistent with a basic lending arrangement because the lender could be forced to settle the contract such that it would not recover its investment; ie the lender effectively could be forced to pay a prepayment penalty to the borrower, even though it was the borrower that chose to prepay the instrument. Mr Kabureck believes that fair value through profit or loss is the most appropriate accounting for prepayable financial assets that could give rise to both additional compensation (upside risk) and 'negative compensation' (downside risk) for the early termination of the contract. He acknowledges that the risk of 'negative compensation' may often be minimal in the current low interest rate environment but notes that over time IFRS 9 will be applied in different interest rate environments and thus the risk of 'negative compensation' may become more pronounced.

- AV3 Mr Kabureck notes that the notion of 'reasonable additional compensation for the early termination of the contract' for prepayment features has been included in IFRS 9 (and the related due process documents) since at least 2009. In reviewing the feedback received in the extensive outreach performed during the IFRS 9 project, including the analysis of comment letters received, and the IASB's deliberations since 2009, he did not find any evidence that concerns were previously raised about the accounting requirements for financial assets with prepayment features that could result in 'negative compensation'. Accordingly, he believes that the subject matter was not raised as a significant concern when IFRS 9 was finalised in 2014 and that a compelling case has not been made to consider the issue now, particularly so close to the effective date of IFRS 9.
- AV4 Mr Kabureck notes that, during some of the IFRS Interpretations Committee and IASB discussions, it was suggested that the effective interest method could be equally applied to a prepayment amount that includes reasonable additional compensation for the early termination of the contract and a prepayment amount that includes reasonable 'negative compensation' for the early termination of a contract because, in both cases, the prepayment amount may be more or less than unpaid amounts of principal and interest. Mr Kabureck disagrees. While he may have been more inclined to support the Exposure Draft if there had been ambiguity about the IASB's previous decisions related to this topic, he believes the requirements in IFRS 9 are clear. The notion of reasonable additional compensation for the early termination of the contract in IFRS 9 clearly accommodates only those circumstances in which the party that chooses to terminate the contract early may be required to compensate the other party. If the party that is forced to accept the early termination of a contract could be required to effectively make a payment to the other party, that is not compensation. Rather such an outcome *penalises*, rather than compensates, the party that is forced to accept the early termination of the contract. Mr Kabureck observes that the notion of 'compensating' and 'penalising' are not the same thing, they are in fact opposites, and he sees little reason to propose amendments that could result in the same accounting for them.
- AV5 Mr Kabureck agrees that the second eligibility condition—that the fair value of the prepayment feature must be insignificant when the entity initially recognises the financial asset—is helpful and should limit the population of financial assets to which the Exposure Draft applies. However, he believes that same argument is also a reason not to support the proposals in the Exposure Draft; that is, if the scope is so narrow, then there is little benefit in making the amendment.
- AV6 Mr Kabureck notes there are other financial assets that will be measured at fair value through profit or loss applying IFRS 9 that were not measured at fair value through profit or loss in their entirety applying IAS 39. The IASB extensively deliberated the 'solely payments of principal and interest' condition, including the types of contractual cash flows that are suitable for amortised cost measurement (versus fair value measurement). Mr Kabureck observes that, given the wide variety of financial assets that exist in practice, there are many financial assets that are not eligible to be measured at amortised cost as a result of a single contractual feature. Given the limited scope and the nature of the

PREPAYMENT FEATURES WITH NEGATIVE COMPENSATION (PROPOSED AMENDMENTS TO IFRS 9)

Exposure Draft, Mr Kabureck is very concerned that it will be seen as an invitation for other requests for exceptions to be submitted. IFRS 9 is a principle-based standard and if one request for a rule-based exception is granted, then Mr Kabureck thinks it is likely that there will be more requests.



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