



30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

INFORMATION FOR OBSERVERS

Board Meeting: 21 June 2007, London

Project: Annual Improvements

Subject: IAS 39 – Treating prepayment penalties as closely related embedded derivatives (Agenda paper 12G)

1. The staff has identified that the following issue would be most appropriately resolved via the annual improvements process.

Issue: Should IAS 39, *Financial Instruments: Recognition and Measurement*, be amended to classify prepayment penalties that are charged to a borrower as closely related to the underlying loan where the penalty only compensates the lender for the changes in the interest rate?

Staff recommendation

2. The staff recommends that the Board:
 - should add this issue to the annual improvements project; and
 - should amend IAS 39 as proposed in paragraph 12 of this paper.

Background

3. The staff has been notified of an apparent inconsistency in the guidance in IAS 39. It relates to penalties for early repayment (i.e. prepayment) of loans and whether these are classified as closely related to the loan.
4. The issue arises, for example, when an entity originates a loan to a borrower and writes an option as part of the loan that allows the borrower to prepay the loan but charges a penalty to the borrower if the option is exercised. The option meets the definition of a derivative in accordance with IAS 39 paragraph 9. The entity must therefore determine whether this embedded derivative (the option) is closely related to the host contract (the loan). The embedded derivative must be separated and accounted for at fair value through profit or loss in accordance with paragraph 11 of IAS 39 if it is not closely related to the host contract.
5. The penalties payable on exercise of the prepayment option vary in practice. Penalties include, among others;
 - i) fixed fee penalties, some of which reduce on a straight line basis over the option exercise period, and
 - ii) penalties that vary in such a way as to compensate the lender for loss of interest income during the period from inception of the loan to the prepayment date.

IAS 39 guidance

6. Paragraph AG33(a) of the application guidance to IAS 39 gives the following example of an embedded derivative that is closely related to the host contract and therefore does not need to be accounted for separately:

‘An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the combined instrument can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of

return that is at least twice what the market return would be for a contract with the same terms as the host contract’.

7. The guidance in paragraph AG33(a) of IAS 39 would suggest that a prepayment penalty that compensates the lender for loss of interest would qualify as closely related.
8. However, paragraph AG30(g) of the application guidance to IAS 39 gives the following example of an embedded derivative that is not closely related to the host contract and therefore does need to be accounted for separately:
‘A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under IAS 32’.
9. The guidance in paragraph AG30(g) of IAS 39 would suggest that a prepayment penalty that compensates the lender for loss of interest income would not qualify as closely related and would therefore need to be accounted for separately. This appears to conflict with the guidance in AG33(a).

Staff recommendation

10. The staff recommends that the application guidance of IAS 39 be amended as proposed in paragraph 12 to make an exception to the example given in paragraph AG30(g) in respect of prepayment penalties that compensate the lender for the loss of interest.
11. **Does the Board agree?**

Drafting

12. The staff recommends that IAS 39 should be amended as follows:

Embedded derivatives (paragraphs 10–13)

...

AG30 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

...

- (g) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under IAS 32. However, a prepayment option that compensates the lender for loss of interest for the period from origination of the loan to the exercise of the prepayment option, as described in paragraph AG33(a), is closely related to the host debt contract.

...

Basis for Conclusions on Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement

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

Reclassification

- BC1 The Board has identified an apparent inconsistency in the guidance in IAS 39. It relates to penalties for early repayment (i.e. prepayment) of loans and whether these are classified as closely related to the loan.
- BC2 The Board has decided to address this inconsistency by amending paragraph AG30(g) of the application guidance of IAS 39 to make an exception to the example of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment penalties that compensate the lender for the loss of interest.