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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:	**December 2008, London**
Project:	**ED Annual Improvements project – Comment analysis**
Subject:	**IAS 39 – Treating loan prepayment penalties as closely related embedded derivatives (Question 34) (Agenda paper 11D)**

INTRODUCTION

1. The purpose of this agenda paper is to present the staff's analysis of the comments received on the proposed amendment discussed in Question 34 of the 2007 exposure draft of Annual Improvements to IFRSs.

STAFF RECOMMENDATION

2. The staff recommends that the Board amend IAS 39 by clarifying that prepayment options, the exercise price of which reimburse the lender for the fair value of lost interest for the remaining term to maturity of the original contract, are closely related to the host debt contract.

3. Based on the comment letters received, the staff proposes revised wording for the amendment in Appendix 1.

BACKGROUND

4. The issue stems from an initial inquiry received noting an apparent inconsistency in the application guidance in IAS 39 paragraphs AG30(g) and AG33(a). It relates to penalties for early repayment (i.e. prepayment) of loans and whether these are classified as closely related to the loan.

5. 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 the borrower a penalty 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 debt). 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.

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 is not 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 recognized 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 suggests that a prepayment penalty that compensates the lender for lost interest would qualify as closely related.

8. However, paragraph AG30(g) of 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 unless certain conditions are met:

> 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 amortized cost of the host debt instrument or the carrying amount of the host insurance contract…

9. The guidance in paragraph AG30(g) of IAS 39 suggests that a prepayment penalty that compensates the lender for lost interest may not qualify as closely related and may therefore need to be accounted for separately. This guidance in AG30(g) appears to conflict with the guidance in AG33(a).

10. However, the staff does not believe that IAS 39.AG33(a) and IAS 39.AG30(g) are in conflict. Rather, these two paragraphs relate to different concepts. IAS 39.AG33(a) deals with the notion of leverage. IAS 39.AG30(g) deals with the presumption that calls, puts or prepayment options are not closely related embedded derivatives unless the embedded derivative has similar economic characteristics to the underlying debt host (as evidenced by 'the option's exercise price [being] approximately equal on each exercise date to the amortized cost of the host debt instrument…')

11. As part of the Annual Improvements to IFRSs ED issued in October 2007, the Board proposed an amendment to AG30(g) to address this inconsistency and solicited comments in Question 34. The proposed wording incorporated a reference within paragraph AG30(g) to paragraph AG33(a).

COMMENT ANALYSIS

12. Of the 75 comment letters received, 54 comment letters included some form of response to question 34. Of the 54 comments, all responses were either supportive 'that in principle the amendment is correct' [CL35] or the response included neither a statement of agreement nor disagreement.

13. Many comment letters included statements noting basic agreement with the proposed amendment, but noted concern that the proposed wording may cause confusion. CL11 states:

> This is because the sentence to be added to AG30(g) can be read in two ways:
>
> View 1: The amended sentence includes two conditions that a prepayment option must meet in order to be considered closely related,
>
> - the first condition being that the exercise price must compensate the lender for loss of interest by reducing the economic loss from reinvestment and
> - the second condition being that the prepayment option must meet all of the conditions contained in AG33(a)
>
> View 2: The prepayment option must meet the conditions contained in AG33(a). The reference to the exercise price that must compensate for the loss of interest does not constitute a second condition that must be met, but merely describes the overall rationale behind a prepayment option.

14. Several respondents recommended removing the proposed reference to 'reinvestment risk' as they feel it creates confusion. Additionally, many respondents believe the proposed reference to AG33(a) should be removed as it does not provide guidance on reinvestment risk and creates potential confusion (as noted in paragraph 11 above).

15. One comment letter noted, "There is a concern that it might create structuring opportunities – because the amendment does not specify to what extent such reduction has to occur – but we see no easy way of addressing that, and anyway we do not believe that concerns about the potential for abuse should determine the content of IFRS."[CL75]

16. One respondent commented that the amount of compensation paid to the lender as a result of exercise of the prepayment option should apply to both the loss of

interest plus other losses incurred by the lender "such as losses due to the need to close associated hedging derivatives as long as par. AG33(a) doesn't apply."[CL13]

STAFF ANALYSIS

17. The staff analysis of the comments received was included in the February 2008 Board meeting Agenda Paper 4B, Appendix 2, "Amendments that require more staff work but cannot be completed in time". They are reproduced below along with staff responses based on additional staff work completed.

Comment Summary from February 2008	**Staff Response**
• Most respondents support achieving consistency but there are some concerns	• Staff believe respondents' concerns have been addressed by the proposals in this agenda paper.
• Unclear to what extent such reduction has to occur and potential structuring issues	• Clarified proposed wording to allow any reduction in lender's loss to be closely related as long as reimbursement does not exceed amount of loss.
• Unclear from proposed wording which calls, puts or prepayment options would in practice need to be bifurcated after the change	• This comment was from CL20 which more fully states that the confusion is due to the cross-reference made to IAS 39.AG33(a). Clarified proposed wording by removing the cross-reference to AG33(a).
• Other situations in paragraph AG33(a) are not addressed	• Clarified proposed wording by removing the cross-reference to AG33(a) to avoid confusion. • No amendment was proposed to paragraph AG33(a) as it is not the focus of this amendment and was originally included in the ED to provide context for the issue.
• The change should also apply when the exercise price compensates the holder for other losses (such as losses due to the need to close associated hedging derivatives) as long as paragraph AG33(a) does not apply	• The staff does not agree with this comment (from CL13). Although a lender may incur losses from hedging activities related to the issuance of debt contracts, the staff does not believe losses associated with closing hedging derivative positions are necessarily closely related to an underlying that is an interest rate or an interest rate index.

18. Respondents (in CL54) also raised an additional issue that could arise when no penalty fees are charged as in the case of a variable rate borrowing or debt issued at a discount such as a zero coupon bond. On initial recognition, when a borrowing is to be carried subsequently at amortised cost, incremental direct costs will be netted against the borrowing's initial carrying amount. If the issuer has the option to settle at any date after the initial drawdown, the option exercise price immediately after the issue date will be the loan's principal amount, which will not be 'approximately equal' to the loan's amortised cost amount when initial costs are substantial. This would still give rise to an embedded derivative issue for the issuer. The staff believes this issue is the principal reason for AG30(g) and continues to believe that if an option's exercise price does not approximately equal the amortised cost of the host debt contract on each exercise date, the embedded prepayment option is not clearly related to the host contract. This feature should continue to be separately analysed using the current (and proposed) guidance in AG30(g).

19. The staff does not believe AG30(g) and AG33(a) are in conflict. Rather, the staff believes these two paragraphs address separate concepts. The staff does believe the potential for confusion exists between the current AG30(g) and AG33(a).

20. Additionally, the current wording of AG30(g) as read creates a difference with US GAAP that considers most prepayment penalties (based on interest rates or credit risk) to be clearly and closely related to debt host instruments.

21. The staff recommends revised wording to address concerns raised by the comment letter responses. The revised wording removes the reference within AG30(g) to AG33(a) to avoid the potential confusion, as noted within numerous comment letters, arising from the proposed reference in the Exposure Draft.

22. Additionally, the staff recommends amending paragraph AG30(g) of IAS 39 to clarify that if the exercise price of a prepayment option compensates the lender only for lost interest the option is closely related to the host debt contract. The

revised wording clarifies the meaning of ‘lost interest’ by referencing to the effective interest rate calculation.

23. The staff has incorporated two versions of the proposed amendments within Appendix 1. The first proposed amendment wording maintains the original and exposure draft formatting. The second proposed amendment wording incorporates the same guidance, but rearranges the wording for easier use. See Appendix 1 for revised amendment wording.

Questions for the Board

24. The staff recommends the second proposed amendment wording (Proposed Wording #2) that incorporates clarifying that lost interest is closely related to a debt host and the second proposed amendment also rearranges AG30(g) for ease of use.

25. **Does the Board agree with the staff’s recommendation including the revised wording in Appendix 1? If not, what does the Board recommend and why?**

Appendix 1 – DRAFTING

The changes proposed by the staff to the ED amendment are marked in Proposed Wording #1 with double underline (added words) and double strike-through (deleted words or letters). The staff also recommends an alternative wording at Proposed Wording #2 that improves the understandability of the application guidance. The staff preference is for the alternative wording (Proposed Wording #2).

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.

…

[Proposed Wording #1]

(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 amortized 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 for which the exercise price compensates the lender for loss of interest by reducing the economic loss from reinvestment risk, as described in paragraph AG33(a), is closely related to the host debt contract.~~ However, if the exercise price of a prepayment option no more than reimburses the lender for the present value of lost interest for the remaining term of the host debt contract, it is closely related to the host debt contract. Lost interest is the excess of the effective interest rate of the original contract and the effective interest rate for a contract with the same terms as the host debt contract.

…

[Proposed Wording #2 - Alternative to replace all of paragraph AG30(g) in its entirety]

(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:

(i) the option's exercise price is approximately equal on each exercise date to the amortized cost of the host debt instrument or the carrying amount of the host insurance contract; or

(ii) the exercise price of a prepayment option no more than reimburses the lender for the present value of lost interest for the remaining term of the host debt contract. Lost interest is the excess of the effective interest rate of the original contract and the effective interest rate for a contract with the same terms as the host debt contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument under IAS 32.

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 was made aware that paragraphs AG30(g) and AG33(a) of IAS 39 could be misinterpreted in practice relating to penalties for early repayment (ie prepayment) of loans and whether these are classified as closely related to the loan. Paragraph AG30(g) addresses the notion of similar economic characteristics within calls, puts or prepayment options embedded in a host debt contract or host insurance contract. Paragraph AG33(a) is intended to address the concept of leverage.

BC2 The Board decided to clarify paragraph AG30(g) of the application guidance of IAS 39 to make an additional 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 lost interest.