

STAFF PAPER

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Project	IFRS 9 <i>Financial Instruments</i> : Symmetric prepayment options		
Paper topic	A possible narrow amendment to IFRS 9		
CONTACT(S)	Uni Choi	uchoi@ifrs.org	+44 (0)20 7246 6964
	Markus Hahn	mhahn@ifrs.org	+44 (0)20 7246 6933
	Kumar Dasgupta	kdasgupta@ifrs.org	+44 (0)20 7246 6902

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Introduction

- At its meeting in December 2016, the Board agreed to add to its agenda a narrow-scope project on IFRS 9 *Financial Instruments* regarding financial assets with symmetric ‘make-whole’ prepayment options. At that meeting, the Board considered the classification of financial assets with such prepayment options applying IFRS 9, together with a summary of feedback from the IFRS Interpretations Committee (the Interpretations Committee). At its meeting in November 2016, Interpretations Committee members suggested that the Board add the topic to its agenda and consider changing the requirements in IFRS 9 such that particular financial assets with symmetric ‘make-whole’ prepayment options would be eligible for amortised cost measurement.¹
- The objective of this paper is to provide the Board with information gathered from additional outreach performed on this issue and to set out a possible narrow exception to IFRS 9 for some financial assets with such symmetric prepayment options. We ask the Board how it would like to proceed.

¹ For the avoidance of doubt, a financial asset is measured at amortised cost only if both of the conditions in paragraph 4.1.2 of IFRS 9 are met. However, this paper discusses only the ‘solely payments of principal and interest’ condition and therefore assumes that the financial asset is held in a ‘hold to collect’ business model (or a ‘hold to collect and sell’ business model for measurement at fair value through other comprehensive income, which presents amortised cost information in profit or loss).

Structure of the paper

3. This paper is structured as follows:
 - (a) brief background on the issue;
 - (b) a summary of information gathered from additional outreach performed;
 - (c) a possible narrow exception for particular financial assets with symmetric prepayment options; and
 - (d) a high-level project timeline.

Background

4. The Interpretations Committee received a query relating to how financial assets with particular contractual prepayment options would be classified applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that meet the ‘solely payments of principal and interest’ (SPPI) condition for measurement at amortised cost if the contractual terms of the instrument include a symmetric ‘make-whole’ prepayment option or a fair value prepayment option. In the submission, the prepayment options are held only by the borrower. A symmetric ‘make whole’ prepayment option allows the borrower to prepay the instrument at an amount that reflects the instrument’s remaining contractual cash flows discounted at a current market interest rate. A fair value prepayment option allows the borrower to prepay at the instrument’s current fair value. In both cases, the prepayment amount may be more or less than unpaid amounts of principal and interest (ie if the borrower chooses to prepay, *either* the borrower *or* the lender can effectively receive a ‘payment’ as a result of that early termination of the contract) and, hence the reference to ‘symmetric’.
5. Paragraph B4.1.11(b) of IFRS 9 addresses contractual terms that permit the early termination of the contract and describe those that result in contractual cash flows that are solely payments of principal and interest. That paragraph states that a contractual term that permits the borrower to prepay a debt instrument (or permits

the lender to put a debt instrument back to the borrower before maturity) results in contractual cash flows that meet the SPPI condition 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.

6. As described in more detail in [Agenda Paper 12F](#) for the December 2016 IASB meeting, we analysed the instruments described in the submission and expressed the view that neither the symmetric ‘make whole’ prepayment option nor the fair value prepayment option meets the SPPI condition, and thus the instruments would be measured at fair value through profit or loss (FVPL) applying IFRS 9. We reached that conclusion because we think paragraph B4.1.11(b) of IFRS 9 accommodates only those instruments for which the party choosing to exercise its option to terminate the contract (in the submission, this can only be the borrower) compensates, or pays a prepayment penalty to, the party that must accept that choice (in the submission, this can only be the lender). However, the prepayment options described in the submission could have the result that the lender is forced to accept an amount that, in effect, represents a payment *to* the borrower, even though the borrower chose to prepay the debt instrument. We do not think an outcome in which the party choosing to terminate the contract *receives* an amount (instead of *pays* an amount) meets the requirements in paragraph B4.1.11(b) of IFRS 9. Specifically, we think that outcome is inconsistent with the notion of ‘reasonable additional compensation for the early termination of the contract’ as that phrase is used in IFRS 9.
7. At its November 2016 meeting, most Interpretations Committee members agreed with the staff’s analysis and conclusion. However, the Interpretations Committee suggested that the Board consider changing the requirements in IFRS 9 in this respect, taking into account the broader range of prepayment options that exist in practice, not only the options described in the submission. Interpretations Committee members also suggested that the Board consider the measurement that provides the most relevant and useful information about particular financial assets that would otherwise meet the SPPI condition, but do not meet that condition only as a result of the existence of a symmetric ‘make whole’ prepayment option.

However, a number of Interpretations Committee members noted that amortised cost measurement would not be appropriate for all such prepayment options, and it is likely to be difficult to define the relevant population.

8. At its December 2016 meeting, the Board agreed to explore a narrow-scope project on IFRS 9 regarding financial assets with symmetric ‘make-whole’ prepayment options. However, at that meeting, a number of Board members expressed concerns about making an exception to the SPPI condition because the Board carefully deliberated that condition during the development of IFRS 9 to ensure that only particular financial instruments are eligible to be measured at amortised cost (ie only those with ‘simple’ contractual cash flows that are solely payments of principal and interest, as those terms are used in IFRS 9). Board members agreed with Interpretations Committee members that it would be inappropriate to measure all financial assets with symmetric ‘make whole’ prepayment options at amortised cost and thus some Board members noted that the scope of any proposed exception must be narrow and done in a ‘surgically precise’ manner so that the principles underpinning the classification and measurement requirements in IFRS 9 remain intact.

Summary of information gathered from additional outreach

9. Subsequent to the Interpretations Committee meeting in November 2016, we received additional information about other symmetric prepayment options that exist in practice. We received that feedback directly from particular financial institutions, and trade organisations representing financial institutions, that hold financial assets with such prepayment options. That feedback was provided on an informal and confidential basis and therefore we are making observations on an aggregated basis only.
10. Based on the feedback, we understand that there is a broad range of symmetric prepayment options in practice:
 - (a) In some jurisdictions, the prepayment options originate from (or are encouraged by) relevant legal or regulatory requirements with respect to

fair competition or dealing and are incorporated into the contractual terms of the contract.² However, in other cases, there is no such legal or regulatory requirement but rather the options are common market practice that exist for commercial purposes (eg to provide customers with payment flexibility).

- (b) The prepayment options exist in many different types of debt instruments, including corporate loans and consumer mortgages.
- (c) Some prepayment options are contingent on the occurrence of specific ‘trigger’ events. For example, in some cases, a borrower has the option to prepay its mortgage only if it sells the underlying property or the lender has the option to terminate the contract early only if the borrower’s credit or collateral is compromised. Other options are freely exercisable by the option holder.
- (d) The prepayment option may be held by only one party to the contract or by both parties.
- (e) The ‘compensation formula’ (or prepayment amount) that is computed upon the early termination of the contract varies. For example, in some cases, the borrower or the lender effectively receives a payment that represents, on a present value basis, the effect of any change in market interest rates since the loan was originally recognised. In other cases, the borrower or lender effectively receives a payment that represents the lender’s gain or loss on breaking an associated hedge (such as an interest rate hedge).

11. As a final observation, we note that the early termination of the contract is *permitted* in some contracts whilst it is *required* (in particular circumstances) in other contracts. For ease of reference, this paper refers to all such contractual

² This paper considers only those prepayment options that are part of the *contractual terms* of the financial asset because IFRS 9 requires the holder to determine whether the asset gives rise to *contractual cash flows* that are solely payments of principal and interest. The holder would not consider, for example, payments that arise only as a result of a government’s or other authority’s legislative powers because that power and the related payments are not contractual terms of the instrument.

terms as ‘prepayment options’ (even though some can be mandatory, rather than optional).

A possible narrow exception for particular financial assets with symmetric prepayment options

Amortised cost measurement

12. The IASB’s long-standing view, which underpins the classification and measurement requirements in IFRS 9, has been that amortised cost provides relevant and useful information about particular financial assets in particular circumstances. That is because, for those assets, amortised cost provides information about 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.
13. 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 relevant and useful information. As stated in the Basis for Conclusions on IFRS 9, the Board 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) to ensure that the reported financial information is useful to users of financial statements.
14. We think it is critical to maintain this fundamental principle. Therefore, we think any proposal to measure particular financial assets with symmetric prepayment options at amortised cost (or at fair value through other comprehensive income (FVOCI), which presents amortised cost information in profit or loss) must be limited to financial instruments for which the effective interest method provides useful and relevant information to the users of financial statements. Consistent with all financial assets measured at amortised cost, this means that information about any variability in contractual cash flows must be appropriately captured by

amortised cost. Accordingly, if an entity measures an asset at amortised cost and revises its estimates of contractual cash flows, IFRS 9 requires the catch-up adjustment described in paragraph B5.4.6:

If an entity revises its estimates of payments or receipts (...), it shall adjust the gross carrying amount of the financial asset ... to reflect actual and revised estimated contractual cash flows. The entity recalculates the gross carrying amount of the financial asset ... as the present value of the estimated future contractual cash flows that are discounted at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10. The adjustment is recognised in profit or loss as income or expense.

The prepayment amount

15. Applying the *existing* requirements in paragraph B4.1.11(b) of IFRS 9, a financial asset may meet the SPPI condition, and thus may be eligible for amortised cost measurement, even if the contractual prepayment amount is more or less than unpaid amounts of principal and interest. This is because paragraph B4.1.11(b) contemplates contractual terms that permit *either the borrower or the lender* to terminate the contract early. Therefore:
- (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.

16. In other words, *depending on which party chooses to terminate the contract early*, the existing notion of ‘reasonable additional compensation for the early termination of the contract’ in IFRS 9 already accommodates a prepayment amount that is more or less than unpaid amounts of principal and interest. In applying the effective interest method for amortised cost measurement, 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, the entity would apply paragraph B5.4.6 of IFRS 9 (reproduced in paragraph 14 of this paper) and make a catch-up adjustment if it revises its estimated cash flows, including any revisions related to the exercise of the prepayment option. This will ensure that amortised cost measurement provides information that is useful and relevant in predicting the contract’s likely actual cash flows.
17. Similarly, in the case of an instrument with a symmetric prepayment option, the repayment amount may be more or less than unpaid amounts of principal and interest. However, the difference between a symmetric prepayment option and the prepayment options described in paragraph 15 is that the former could have the result that the party that triggers the early termination of the contract may effectively receive a payment *from* the other party, rather than pay compensation *to* the other party. Some have colloquially referred to this as ‘negative compensation’.
18. While ‘negative compensation’ does not meet the SPPI condition, in terms of the *mechanics* of amortised cost measurement, we think the effective interest method would work in the same way as described in paragraph 16 as long as the symmetric prepayment option does not introduce any different (or additional) contractual cash flow amounts compared to the instruments that are currently accommodated by paragraph B4.1.11(b). To illustrate, consider the contractual cash flow amounts of the following two instruments:
- (a) **Asset A (‘asymmetric prepayment option’)**: Asset A is a prepayable financial asset that meets the requirements in 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 any change in market interest rates since Asset A was originally recognised.

Therefore, if the borrower decides to prepay Asset A and market interest rates have decreased, then the borrower must compensate the lender for the lender's 'lost interest' over Asset A's remaining term.

But if the borrower decides to prepay and market interest rates have increased (or stayed the same), then there is no additional amount due.

Correspondingly, if the lender decides to put Asset A back to the borrower and market interest rates have increased, then the lender must compensate the borrower for the effect of that change in interest rates over Asset A's remaining term. If the lender decides to terminate early and market interest rates have decreased (or stayed the same), then there is no additional amount due.

- (b) **Asset B ('symmetric prepayment option'):** Asset B is the same as Asset A except it has a symmetric prepayment option and therefore does not meet the requirements in paragraph B4.1.11(b). Specifically, the additional payment *amount* does not depend on which party chooses to exercise its option to terminate the contract early. Instead, that amount depends only on the movement in market interest rates since the asset was originally recognised. Therefore, if the contract is terminated early (by *either* party) and market interest rates have decreased, the lender will effectively receive a payment representing its 'lost interest' over Asset A's remaining term. Correspondingly, if the contract is terminated early (by *either* party) and market interest rates have increased, the borrower will effectively receive a payment that represents the effect of that change in interest rates over Asset A's remaining term.

19. As illustrated above, Asset B does not introduce any different contractual cash flows compared to Asset A; that is, in all cases, the prepayment amount reflects unpaid amounts of principal and interest plus (or minus) the effect of changes in market interest rates. Asset B changes only the circumstances (or frequency) in

which those contractual cash flows could arise. Or, to use the colloquial wording introduced earlier in this paper, Asset B changes the ‘sign’ of the compensation payment such that it introduces ‘negative’ compensation (in addition to ‘positive’ compensation).

20. On this basis, we think that the effective interest method (and thus amortised cost measurement) could be applied to (and could provide useful information to users of financial statements about) the contractual cash flows arising from particular symmetric prepayment features. Specifically, we think the mechanics of amortised cost measurement would be appropriate for a financial asset with a symmetric prepayment option *as long as* the symmetric prepayment option does not introduce any contractual cash flow amounts that are different from the cash flows that are already accommodated by the existing requirements in paragraph B4.1.11(b), as illustrated by the two instruments set out in paragraph 18.

21. Therefore, we recommend a narrow exception for particular financial assets with symmetric prepayment options and, specifically, recommend that the scope of that proposed exception is restricted to those symmetric prepayment options that would have met the requirements in paragraph B4.1.11(b) except for the fact that they could result in ‘reasonable *negative* compensation for the early termination of the contract’. Said another way, the proposed exception would accommodate only those symmetric prepayment options that change the ‘sign’ of the compensation amount; ie if paragraph B4.1.11(b) would accommodate a ‘positive’ compensation amount, then the proposed exception would accommodate the same ‘negative’ compensation amount.

22. But the proposed exception would *not* accommodate any other prepayment amounts. This means that if a prepayment amount would have ‘failed’ the requirements in paragraph B4.1.11(b) for any reason other than the ‘sign’ (or direction) of a compensation payment, then it will also ‘fail’ the proposed exception. We think the Board’s focus when developing the requirements in paragraph B4.1.11(b) was to accommodate prepayment amounts that included compensation for any interest rate differential (ie differences in the market interest rate) between the prepaid instrument and a ‘new’ (or replacement) instrument; that

is, the approximate present value of any lost interest income for the lender (or any extra interest expense for the borrower) due to the early termination of the contract. As a result, for example, a prepayment amount that includes a payment that reflects changes in an equity or commodity index does not meet the requirements in paragraph B4.1.11(b) even if such a payment must be ‘positive’ for the party that is forced to terminate the contract early. Therefore, such a prepayment amount would not meet the proposed exception described in this paper. Similarly, a financial asset that is prepayable at fair value (or an asset that is prepayable at an amount that includes the fair value ‘cost’ to terminate a hedging instrument) does not meet the requirements in paragraph B4.1.11(b) because such a prepayment amount reflects many factors unrelated to the simple notion of compensating for interest rate changes due to the early termination of the contract (and thus fair value measurement is more appropriate for financial instruments with such ‘complex’ cash flows). Therefore, such prepayment amounts would not meet the proposed exception in this paper.

An additional eligibility condition

23. In addition to the constraints on the prepayment amounts discussed above, we think the Board should consider whether an additional eligibility condition is necessary to ensure that the scope of the proposed exception is sufficiently narrow. We think this is consistent with the recommendation from Interpretations Committee members, and the views expressed by some Board members at the December 2016 meeting, that the scope of any exception to the SPPI condition is carefully constrained.
24. As noted earlier in this paper, measuring any financial asset with a symmetric prepayment option at amortised cost would be an exception to the SPPI condition. That is, ‘negative compensation’ is not consistent with a basic lending arrangement (as that notion is used in IFRS 9 to underpin the SPPI condition) because it could have the result that a lender is forced to settle the contract in a way that it would not recover its investment and, similarly, a borrower could be forced to settle the contract in a way that it would repay more than it owes.

25. Given that this proposal would be an exception to the SPPI condition and the notion of a basic lending arrangement, which are underlying principles of the classification and measurement model in IFRS 9, and to avoid extending amortised cost measurement too broadly, we think an additional eligibility condition is appropriate. Specifically, as an additional condition, we recommend that a financial asset with a symmetric prepayment option is eligible for measurement at amortised cost (or FVOCI, subject to the business model condition) only if the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. We think this would be a straight-forward way to limit the scope of the exception and to ensure that financial assets are not measured at amortised cost if it is likely that non-SPPI cash flows will occur.
26. Moreover, we note that requiring this additional eligibility condition is consistent with the *existing* exception in IFRS 9 for another narrow group of prepayable assets. That is, applying paragraph B4.1.12 of IFRS 9, prepayable financial assets that are acquired at a discount or premium and are prepayable at the contractual par amount (eg purchased credit-impaired financial assets that are contractually prepayable at par) may be eligible for measurement at amortised cost (or FVOCI, subject to the business model condition) if the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset.

Effective date and transition

Effective date

27. If the Board agrees with the recommendations in this paper, we recommend that the proposed effective date is the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018. We think that entities should initially apply IFRS 9 taking into account the effect of the exception described in this paper. We think it would be inefficient and burdensome for entities to initially apply the SPPI condition without this exception, and then be required to change the classification and measurement of some financial assets

when the exception becomes effective at a later date. Of course, this recommendation is ultimately subject to the project timeline discussed below.

Transition

28. Consistently with the general transition requirements in IFRS 9, and specifically the transition requirements for the SPPI condition (including the transition for the limited amendments to that condition issued in 2014), we recommend that the proposed exception described in this paper is applied retrospectively.
29. However, we recommend an additional transition provision similar to what is provided in IFRS 9 for other aspects of the SPPI condition; in particular, the provision in paragraph 7.2.5 of IFRS 9 for the existing exception for the prepayable assets described in paragraph 26. Specifically, we think that if it is impracticable (as defined IAS 8) for an entity to assess whether the fair value of a prepayment feature was insignificant on the basis of the facts and circumstances that existed at the initial recognition of the financial asset,³ then the entity would assess the SPPI condition on the basis of the facts and circumstances that existed at initial recognition *without taking into account* the proposed exception described in this paper.
30. If an entity applies the transition provision described in paragraph 29 (and thus assesses the SPPI condition *without taking into account* the proposed exception), we think the entity should be required to disclose the carrying amount of those financial assets until they are derecognised. That is the same disclosure requirement that accompanies the transition provisions for other aspects of the SPPI condition (see paragraphs 7.2.4-7.2.5 of IFRS 9 and paragraphs 42R-42S of IFRS 7 *Financial Instruments: Disclosures*). The IASB concluded that this disclosure provides useful information about how an entity assessed the SPPI condition on transition to IFRS 9 (ie whether it applied the SPPI condition *including* the exception, or *without* the exception) and thus enhances

³ This might be the case if the entity had previously designated the financial asset under the fair value option applying IAS 39 *Financial Instruments: Recognition and Measurement*. However, in most cases, we think that the entity will have the required fair value information for the prepayment option because that information would have been required to apply the embedded derivative requirements in IAS 39.

comparability between different entities and for a single entity over time. Given the narrow scope of the exception described in this paper, and in particular the fact that the additional eligibility condition (discussed in paragraphs 23-26) means that it is unlikely that non-SPPI cash flows will occur, we do not think any additional disclosures are necessary.

Project timeline

31. If the Board decides to proceed with the proposed exception described in this paper, we think that proposal should be published as quickly as possible so that it would be possible to align the effective date of the amendment (if finalised) with the effective date of IFRS 9.
32. We have prepared a high-level project timeline assuming that the comment period is 30 days. We will ask the Due Process Oversight Committee for its approval of that comment period at its next meeting (and thus are not asking the Board to discuss it at this meeting).
33. We would like to emphasise that the timeline indicated below is very tight for all parties involved (the Board, the staff and any interested party affected by these proposed amendments). We are aware of the risks of such a timeline and we are still recommending the same so that it is possible to complete this project before the effective date of IFRS 9; ie 1 January 2018. As discussed in paragraph 27, we think there are significant benefits if entities are able to initially apply IFRS 9 *taking into account* the effect of the exception described in this paper.

Timeline	Project plan
February 2017	Board finishes deliberations of the proposed exception, including the comment period, due process steps and permission to ballot Proceed with drafting those amendments in an expeditious manner
April 2017	Publish an Exposure Draft by the end of the month
May 2017	Comment period ends
June-July 2017	Board redeliberations
October 2017	Issue final amendment by the end of the month

Question for the IASB

1. Does the Board agree with the staff's recommendation to propose a narrow exception to IFRS 9 so that a prepayable financial asset would be eligible to be measured at amortised cost (or at fair value through other comprehensive income, subject to the business model condition) if:

(a) the financial asset would otherwise meet the requirements in paragraph B4.1.11(b) but does not do so only as a result of the 'symmetric' nature of the prepayment feature;

and

(b) when the entity initially recognised the financial asset, the fair value of the symmetric prepayment feature is insignificant.

2. Does the Board agree that the proposed effective date for the exception should be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018?

3. Does the Board agree that the proposed exception should be applied retrospectively, subject to the transition provision described in paragraph 29 (and accompanying disclosure described in paragraph 30)?