STAFF PAPER

IASB Meeting

July 2017

Project Prepayment Features with Negative Compensation

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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.

Purpose of this paper

1. Agenda paper 3A discusses the issues for the International Accounting Standard Board’s (the Board’s) redeliberation of the two eligibility conditions proposed in the Exposure Draft (ED) Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9). Agenda paper 3B discusses how to proceed with the submission received by the IFRS Interpretations Committee (the Committee) related to a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability.

2. The purpose of this paper is to set out the staff’s recommendations on the issues in those agenda papers. We think the issues are interrelated and effectively form a ‘package’ for the finalisation of the amendments to IFRS 9. Consequently, we are presenting the recommendations, and asking the Board for decisions, on the basis of that package.

Staff recommendation

3. The staff recommend the following package for the finalisation of the amendments to IFRS 9:
(a) Confirm the first eligibility condition proposed in the ED, and retain the explanation of its application in the Basis for Conclusions (subject to particular clarifications described in paragraphs 20—23 of this paper);

(b) Remove the second eligibility condition proposed in the ED and, as a result, remove the transition provision and disclosure requirement that correspond to that condition (for both existing IFRS preparers and first-time adopters of IFRS);

(c) Align the existing exception in paragraph B4.1.12 of IFRS 9 with the recommendations set out in bullets (a) and (b) with the result that the eligibility condition in paragraph B4.1.12(b) would accommodate reasonable *negative* compensation for the early termination of the contract.

(d) Highlight in the Basis for Conclusions on the amendments the relevant accounting requirements for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability.

**Staff analysis and recommendations**

*First eligibility condition: reasonable negative compensation for the early termination of the contract*

4. As discussed in Agenda Paper 3A, nearly all respondents agreed with the first eligibility condition proposed in the ED. Respondents supported the rationale set out in the Basis for Conclusions and agreed that this condition achieves the Board’s objective to capture those financial assets for which the effective interest method provides useful information to users of financial statements.

5. We recommend that the Board confirm this eligibility condition. It is necessary to ensure that the scope of the amendments targets a specific population of prepayable financial assets; ie those 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 that may give rise to reasonable *negative* compensation for the early termination of the contract.
6. We note that many respondents were concerned that the Basis for Conclusions on
the ED interpreted or provided additional guidance on the meaning of ‘reasonable
compensation for the early termination of the contract’ as that notion is used in
paragraph B4.1.11(b) of IFRS 9 and in the first eligibility condition proposed in
the ED. Our analysis of those concerns, and our related recommendation, is
discussed below in paragraphs 20—23.

**Second eligibility condition: the fair value of the prepayment feature is
insignificant at initial recognition**

7. As described in Agenda Paper 3A, respondents had mixed views about the second
eligibility condition proposed in the ED. Respondents who agreed with that
condition generally supported it for the reasons set out in the Basis for
Conclusions. However other respondents disagreed with the second eligibility
condition and expressed various views and concerns about matters such as how
difficult the condition would be to apply, whether it would unduly restrict the
scope of the amendments and whether it would achieve the Board’s stated
objective. Some of the respondents who stated that the second eligibility
condition would not achieve the Board’s stated objective (ie to restrict the scope
of the amendments so that financial assets are eligible to be measured at amortised
cost only if it is unlikely that prepayment, and thus negative compensation, will
occur) suggested alternatives that they thought would better achieve that
objective.

8. Consistent with the Board’s considerations set out in the Basis for Conclusions on
the ED, we think that the scope of the amendments must be sufficiently narrow so
that amortised cost measurement is not extended beyond the population of
financial assets for which the effective interest method can provide useful
information. As described in paragraph BC8 of that Basis for Conclusions, the
Board intended that the amendments would target a specific population of
financial assets. The Board noted 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 Board observed that such a scope would facilitate the timely
completion of any amendments given the proximity to the effective date of
IFRS 9. We think that having a second eligibility condition is helpful to precisely identify the relevant population of prepayable assets.

9. In addition, as discussed in Agenda Paper 3A, we think that the second eligibility condition proposed in the ED would, in some cases, achieve the Board’s objective. That is because the fair value of the prepayment feature indeed would consider the likelihood that prepayment will occur. If it is very unlikely that prepayment will occur, then the fair value of the prepayment feature will be insignificant. We note that this notion already exists in paragraph B4.1.12 of IFRS 9 to determine eligibility for the existing exception related to prepayable financial assets that are acquired (or originated) at a premium or discount to the contractual par amount but are prepayable at that contractual par amount. We are not aware of any concerns about the effectiveness of that eligibility condition in paragraph B4.1.12(c) to capture those prepayments that are unlikely to occur.

10. However, we acknowledge some of the concerns about the second eligibility condition expressed by respondents. Specifically, we are sympathetic to the concern that the fair value of a prepayment feature will also reflect the probability that reasonable positive compensation will occur, and in some circumstances, the fair value of the prepayment feature may be more than insignificant due largely (or entirely) to such positive compensation. In those cases, the financial asset may not meet the second eligibility condition even though the holder expects that it is very unlikely that negative compensation will occur. This outcome arguably would be inconsistent with the existing requirements in paragraph B4.1.11(b) of IFRS 9, which do not require a holder to assess the fair value of a prepayment feature that may give rise to reasonable positive compensation for the early termination of the contract.

11. We also note the concerns that the fair value of the prepayment feature could be insignificant even if it is likely that negative compensation may occur. That could be the case if the compensation structure of the prepayment feature is symmetric such that the effect of reasonable negative compensation on the feature’s fair value is offset by the effect of reasonable positive compensation, or if a financial asset can be prepaid at an amount close to its current fair value as the intrinsic value of such an option would be nil.
12. Consequently, we acknowledge that there is evidence that the second eligibility
does not achieve the Board’s objective in some circumstances, and may restrict
the amendments in a way that the Board did not intend in other circumstances.

13. Agenda Paper 3A describes and analyses some alternatives to the second
condition that were suggested by respondents. We note that those alternatives
were not discussed in the ED and therefore interested parties have not had the
opportunity to provide feedback on their operationality, effectiveness or
appropriateness. Moreover, we are unconvinced that the alternatives would better
achieve the Board’s objective without introducing more complexity to IFRS 9
compared to the second eligibility condition proposed in the ED. For example,
we think that looking only at the prepayment feature’s intrinsic value would not
limit the scope of the amendments to those financial assets that are unlikely to be
prepaid and therefore would not achieve the Board’s objective. Furthermore, we
think that determining the fair value of only the ‘negative compensation
component’ of a prepayment feature in a consistent and reliable manner could be
very difficult to operationalise and would be akin to the componentisation of
derivatives, which is not otherwise permitted or required by IFRS Standards.

14. Finally, we acknowledge that the amendments would be simpler to implement
without the second eligibility condition. Creating an additional exception in
IFRS 9 with the second eligibility condition adds complexity to that IFRS
Standard, and we acknowledge that such complexity would be reduced if the
accounting for reasonable ‘negative’ compensation for the early termination of the
contract is aligned with the accounting for reasonable ‘positive’ compensation for
the early termination of the contract.

15. Therefore, on balance, we recommend that the Board remove the second
eligibility condition. Furthermore, having considered the potential benefits and
challenges of the alternatives suggested by respondents, we recommend that the
Board does not replace the second eligibility condition with any of those
alternatives.
16. We note that the consequence of this recommendation is that the transition provision and disclosure requirement related to the second eligibility condition proposed in the ED would also be removed.\(^1\)

17. However, we observe that our recommendation to remove the second eligibility condition means that the scope of the amendments would depend entirely on the first eligibility condition. In other words, the first eligibility condition alone must ensure that the scope of the amendments is limited to those prepayable financial assets for which the effective interest method provides useful information to users of financial statements. Consequently, if the Board agrees with our recommendation to remove the second eligibility condition, then we think it is particularly important to retain the explanation in the Basis for Conclusions related to the notion of ‘reasonable compensation for the early termination of the contract’ in order to support the consistent application of the first eligibility condition. The retention of that explanation is discussed in paragraphs 20—23 of this paper.

*A consequence of the staff’s recommendations related to the two eligibility conditions*

18. As a result of the recommendations set out in paragraph 3, particularly the recommendation to remove the second eligibility condition, the accounting requirements for reasonable *negative* compensation for the early termination of the contract would be aligned with the accounting requirements for reasonable *positive* compensation for the early termination of the contract.

19. As a consequence, we think that the eligibility condition in paragraph B4.1.12(b) of IFRS 9 would also treat those ‘compensation’ amounts in the same way. In other words, the existing exception in paragraph B4.1.12 would accommodate reasonable *negative* compensation for the early termination of the contract.

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\(^{1}\) The proposed transition provision set out the requirements for how an entity would apply the second eligibility condition when the entity first applies the amendments (if it is impracticable to apply that condition retrospectively) and the proposed disclosure requirement applied only if the entity applied that proposed transition provision.
Basis for Conclusions: reasonable compensation for the early termination of the contract

20. As noted above in paragraph 6, many respondents expressed concern that the Basis for Conclusions on the ED interpreted or provided additional guidance on the meaning of ‘reasonable compensation for the early termination of the contract’ as that notion is used in the paragraph B4.1.11(b) of IFRS 9 and in the first eligibility condition proposed in the ED. Specifically, these concerns were raised in the context of the discussion in the Basis for Conclusions about the classification of instruments that are prepayable at their current fair value and instruments that are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument.

21. We think the Basis for Conclusions on the ED contained the explanation about the meaning of ‘reasonable compensation for early termination of the contract’ because it is relevant to understanding the Board’s intention for how the first eligibility condition would be applied, and specifically, to understand the types of prepayment amounts that the Board expected to meet (and not meet) that condition. In addition, we note that the submission to IFRS Interpretations Committee on this issue asked specifically about the classification of a financial asset that can be prepaid at its current fair value.

22. Having said that, the staff acknowledge that the wording in the Basis for Conclusion on the ED may have been too absolute in its conclusions. We acknowledge that there may be circumstances in which such a prepayment amount may be consistent with the notion of ‘reasonable compensation for the early termination of a contract’. For example, that may be the case when the prepayment amount will approximate unpaid amounts of principal and interest plus compensation for only changes in the market benchmark interest rate. However, the staff continues to think that a prepayment amount that reflects the instrument’s current fair value (or includes the fair value cost to terminate an associated hedging instrument) is not always consistent with a notion of ‘reasonable compensation for the early termination of a contract’ for the reasons set out in the ED and therefore entities cannot automatically presume that all such instruments will meet the first eligibility condition. Rather entities will need to make that assessment on the basis of the instrument’s specific contractual cash
flow characteristics. Similarly, the same may be the case when a financial asset that is prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument. As above, it is possible that the fair value cost to terminate the associated hedging instrument is consistent with the notion of ‘reasonable compensation for the early termination of a contract’ but that will not always be the case.

23. Accordingly, we recommend that the Board retain that explanation in the Basis but clarify the wording to acknowledge that a prepayment amount that reflects the instrument’s current fair value (or includes the fair value cost to terminate an associated hedging instrument) may meet the first eligibility condition if (and only if) that prepayment amount reflects unpaid amounts of principal and interest, which may include reasonable compensation for the early termination of the contract. As noted above, if the Board agrees with our recommendation to remove the second eligibility condition, we think this explanation in the Basis for Conclusions is particularly important in order to support the first eligibility condition to ensure that the scope of the amendments is not extended beyond the population of financial assets for which the effective interest method can provide useful information.

**Basis for Conclusions: modification or exchange of a financial liability that does not result in derecognition**

24. Agenda Paper 3B discusses a submission received by the Committee regarding the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. The request asked whether, applying IFRS 9, an entity recognises any adjustment to the amortised cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification or exchange.

25. In March 2017, the Committee tentatively decided not to add this matter to its standard-setting agenda because it concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. The tentative agenda decision (reproduced in Agenda Paper 3B) confirmed the accounting required by IFRS 9.
26. The Board discussed this issue in February 2017 and agreed with the Committee’s technical conclusions on the matter and also concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities. Consequently, at that meeting, the Board decided that standard-setting is not required in this situation. However, given the importance of the matter, the Board said that it would consider other ways to highlight the relevant accounting required by IFRS 9.

27. At its June 2017 meeting, the Committee discussed the comments received on the tentative agenda decision published in March 2017. Although agreeing with the technical analysis summarised in the tentative agenda decision, in the light of the comments received, the Committee decided not to finalise the agenda decision and instead referred the matter to the Board. Agenda Paper 3B highlights some of the main concerns raised in the comment letters, summarises the Committee’s discussion on finalising the agenda decision and suggests a possible solution as to how the Board could highlight the relevant accounting required by IFRS 9. As described in that paper, given that the Committee decided not to finalise the agenda decision on the matter, we think it is important to identify another way to highlight the relevant accounting required by IFRS 9. In that regard, we think the amendments to IFRS 9 for prepayment features with negative compensation provide an opportunity for the Board to do so in a timely manner without consuming additional resources. We think it is critical to confirm that accounting as soon as possible to address any uncertainty in practice about those requirements in IFRS 9. The requirements in paragraph B5.4.6 of IFRS 9 are important for financial assets and financial liabilities measured at amortised cost in order to account for revisions of estimated contractual cash flows. This is applicable for both revisions related to an exercise of a prepayment feature, or a modification (or exchange) of a financial liability that does not result in derecognition.

28. Accordingly, we recommend that the Board highlight, in the Basis for Conclusion on the amendments to IFRS 9, the accounting requirements for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. Specifically, we think it would be appropriate to highlight that:
(a) the requirements in paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments or receipts, including changes in cash flows arising from a modification or exchange of a financial liability that does not result in the derecognition of the financial liability. This is consistent with the requirements in IFRS 9 for modifications of financial assets that do not result in derecognition, and with the definition of amortised cost in Appendix A of IFRS 9 that applies to both financial assets and financial liabilities; and

(b) in applying paragraph B5.4.6 of IFRS 9 to a modification or exchange of a financial liability that does not result in the derecognition of the financial liability, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any adjustment to the amortised cost of the financial liability in profit or loss as income or expense at the date of the modification or exchange.
Question for the Board

1. Does the Board agree with the staff’s package of recommendations for the finalisation of the amendments to IFRS 9:

   (a) Confirm the first eligibility condition proposed in the ED, and retain the explanation in the Basis for Conclusion (subject to the clarifications discussed in paragraphs 20—23 of this paper);

   (b) Remove the second eligibility condition proposed in the ED, and as a result, remove the proposed transition provision and disclosure requirement that correspond to that condition;

   (c) Align the existing exception in paragraph B4.1.12 of IFRS 9 with the recommendations set out in bullets (a) and (b) above with the result that the eligibility condition in paragraph B4.1.12(b) would accommodate reasonable negative compensation for the early termination of the contract;

   (d) Highlight in the Basis for Conclusions the relevant accounting requirements for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability.

   If the Board does not agree with the staff’s recommendations to remove the second eligibility condition proposed in the ED, then the next section of this paper is relevant.

Additional issues if the Board decides not to remove the second eligibility condition

29. If the Board decides to retain the second eligibility condition, then we think there are additional issues that need to be considered. If the Board agrees with the staff’s recommendations in Question 1, then the questions in this section are not relevant.

Refining the description of ‘negative compensation’

30. As described in Agenda Paper 3A, a respondent raised an issue about how the ED described the notion of negative compensation. Specifically, the respondent
noted that the description does not seem to consider the case where the triggering event is not caused by either party (ie early termination can be caused only by an external event such as a change in law or regulation). The respondent said that it is unclear, in such cases, how to assess a prepayment amount that includes compensation for the early termination of the contract; ie whether that compensation amount would be considered to be ‘positive’ or ‘negative’.

31. The second eligibility condition creates a difference between the requirements for reasonable positive compensation and the requirements for reasonable negative compensation. Therefore, we think it is important to clearly distinguish between those two populations so that preparers know which requirements to apply to a particular instrument.

32. We think the fact pattern described by the respondent is similar to the description of negative compensation proposed in paragraph B4.1.12A(a) of the ED. That is because, in both cases, a party to the contract could be forced to pay a ‘compensation’ amount even though it did not choose (or otherwise cause) the early termination of the contract. For example, applying the description in paragraph B4.1.12A(a) of the ED, negative compensation would arise when the lender is forced by the borrower to terminate the contract early and, as a result of that early termination, the lender must pay a ‘compensation’ amount to the borrower. In that case, the lender is forced to settle the contract in a way that it would not recover its investment. Similarly, in the fact pattern described by the respondent, the lender could be forced by events that are outside its control to terminate the contract early and, as a result of that early termination, the lender must pay a ‘compensation’ amount to the borrower. In other words, in both cases, the lender may be forced to pay a ‘compensation’ amount even though it did not choose to terminate the contract early (or otherwise cause such termination to occur).

33. Consequently, if the Board decides to retain the second eligibility condition, then we think those two cases should be treated the same way. Thus we recommend clarifying the description of ‘negative compensation’ to include the fact pattern described by the respondent.
**Interaction with the existing exception in paragraph B4.1.12 of IFRS 9**

34. Many respondents expressed concern about the explanation in the Basis for Conclusions on the ED about the interaction between the existing exception in paragraph B4.1.12 of IFRS 9 (applicable to assets that are acquired at a premium or discount but are prepayable at the contractual par amount) and the exception proposed in the ED. They expressed the view that the amendments should apply to financial assets that are originated (or acquired) at a discount or a premium. As explained in Agenda Paper 3A, paragraph BC19 in the Basis for Conclusions on the ED was intended only to observe that, as drafted, those two exceptions are mutually exclusive. In its deliberations leading to the ED, the Board had not considered whether a single financial asset should be able to meet both exceptions. If the Board decides to retain the second eligibility condition proposed in the ED, we think it is necessary to consider the interaction between these two exceptions.

35. The staff note that if the exception in paragraph B4.1.12 accommodated prepayable financial assets with negative compensation, then the scope of that exception would be wider. A financial asset would be eligible for amortised cost measurement when it has two ‘problems’; ie the prepayment amount does not reflect unpaid amounts of principal and interest and the prepayment amount may include negative compensation. However, the exception in paragraph B4.1.12 applies only to financial assets that are very unlikely to be prepaid; eg many purchased credit-impaired financial assets with contractual prepayment features. Therefore, if that exception accommodated prepayment features that may result in reasonable negative compensation, then it would capture only those prepayable financial assets that are very unlikely to actually result in such negative compensation.

36. Consequently, if the Board decides to retain the second eligibility condition, we recommend that the exception in paragraph B4.1.12 of IFRS 9 – specifically, the prepayment amount described in paragraph B4.1.12(b) – accommodates prepayment features that may result in reasonable negative compensation for the early termination of the contract.
**Transition and disclosure**

37. If the second condition is retained, then we think the corresponding transition provision and disclosure requirement proposed in the ED should also be retained. The transition provision sets out the requirements for how an entity applies the second eligibility condition when the entity first applies the amendments (if it is impracticable to apply that condition retrospectively) and the disclosure requirement provides useful information to users of financial statements about how an entity assessed the contractual cash flow characteristics of prepayable financial assets when it applies the amendment.

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(a) Clarify the description of ‘reasonable negative compensation for the early termination of the contract’ to include the fact pattern described in paragraph 30; ie a fact pattern in which the early termination of the contract is not caused by either party but rather is caused only by an external event such as a change in law or regulation;

(b) Amend the exception in paragraph B4.1.12 of IFRS 9, specifically, the prepayment amount described in paragraph B4.1.12(b), so that it accommodates prepayment features that may result in reasonable negative compensation for the early termination of the contract; and

(c) Confirm the transition provision and related disclosures proposed in the ED.