

STAFF PAPER

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Project	Prepayment Features with Negative Compensation		
Paper topic	Technical re-deliberation: eligibility conditions		
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Introduction

1. At its June 2017 meeting, the International Accounting Standard Board (the Board) identified the key issues to be discussed in its redeliberations of the Exposure Draft (ED) *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9). This paper discusses the issues relating to the two eligibility conditions proposed in that ED.
2. We think some of the issues in this paper are interrelated with the issue discussed in Agenda Paper 3B and together those matters 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 that package in Agenda Paper 3C.

Structure of this paper

3. This paper is structured as follows:
 - (a) proposals in the ED with respect to the two eligibility conditions (paragraph 4);
 - (b) the first eligibility condition (paragraphs 5—7);
 - (c) the second eligibility condition:

- (i) the feedback received (paragraphs 8—12)
- (ii) the objective of the condition (paragraphs 13—16)
- (iii) whether the condition is effective in restricting the scope (paragraphs 17—24)
- (iv) whether the condition is effective in restricting the scope in the way the Board intended (paragraphs 25—32)
- (v) whether the condition can be operationalised (paragraphs 33—34)
- (vi) alternatives considered (paragraphs 35—42)
- (vii) overall observations on the condition whether the condition can be operationalised (paragraphs 43—46);
- (d) additional matters to be discussed if the Board decides to retain the second eligibility condition (paragraphs 47—62); and
- (e) the Basis for Conclusions on the ED: discussion on ‘reasonable compensation for the early termination of the contract’ (paragraphs 63—65).

Proposals in the ED

4. The ED proposed a narrow exception to IFRS 9 *Financial Instruments* for particular prepayable 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 the prepayment feature. Specifically, such a financial asset would be eligible to be measured at amortised cost or at fair value through other comprehensive income (FVOCI), 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 (hereafter called the first eligibility condition); and

- (b) when the entity initially recognises the financial asset, the fair value of the prepayment features is insignificant (hereafter called the second eligibility condition).

First eligibility condition

5. Nearly all respondents who answered this question agreed with the first eligibility condition. Specifically, most respondents said that reasonable negative compensation for the early termination of the contract should not, in itself, prohibit a financial asset from qualifying for amortised cost measurement. These respondents supported the Board's rationale for this eligibility condition and agreed that it achieves the Board's objective to capture those financial assets for which the effective interest method provides useful information to users of financial statements. However, many of these respondents expressed concern that the Basis for Conclusions on the ED seems to interpret or provide 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.
6. The staff's view on the first eligibility condition is unchanged. That is, we think that the condition is necessary to ensure the scope of the amendments targets a specific population of prepayable financial assets for which amortised cost would provide useful information, ie the amendments capture those 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 that may give rise to reasonable *negative* compensation for the early termination of the contract.
7. The staff's analysis of respondents' view that the Basis for Conclusions on the ED contains additional or interpretive guidance is in paragraphs 63—65 of this paper.

Second eligibility condition

Feedback received

8. The Board proposed the second eligibility condition to ensure the scope of the amendment is 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 have a narrow scope and 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 a narrow scope would facilitate the timely completion of any amendments given the proximity to the effective date of IFRS 9.
9. 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 it.
10. Most of the respondents who disagreed with the second eligibility condition said that the treatment of prepayment features with negative compensation should be aligned with the treatment of prepayment features with positive compensation. Therefore, they expressed the view that the first eligibility condition is sufficient and the second condition should be removed because it creates asymmetry in accounting treatment.
11. Of those respondents who disagreed with the second eligibility condition, some said that the second eligibility condition is unduly restrictive while others said that the condition does not restrict the scope of the amendments in accordance with the Board's objective, ie to ensure that financial assets are eligible to be measured at amortised cost only if it is unlikely that prepayment (and thus negative compensation) will occur.

12. Respondents expressed mixed views on the difficulty of assessing whether the fair value of a prepayment feature is insignificant when the entity initially recognises the financial asset. Some said that assessment would be very difficult while others said that it would be straightforward to operationalise.

The objective of the second eligibility condition

13. Amortised cost of a financial instrument is calculated using the effective interest method. This method allocates interest revenue or interest expense over the relevant period using the effective interest rate (EIR), and in doing so, links the carrying amount recorded on initial recognition to the ultimate contractual cash flows. Therefore, amortised cost measurement provides useful information about a financial asset when its contractual cash flows can be faithfully represented as a stable stream of interest revenue calculated with the EIR, which is determined at initial recognition. As an allocation mechanism, amortised cost works best for financial assets with contractual cash flows that are ‘fixed’ (ie those that are known at contract inception and that are not contingent) both in timing and amount. However, limiting amortised cost measurement to only financial assets that have such ‘fixed’ contractual cash flows would be a narrow population. The Board acknowledged that amortised cost could also usefully allocate the effective return for financial assets with particular types of variability in their contractual cash flows; ie encapsulated in IFRS 9 as cash flows that are solely payments of principal and interest (SPPI), which, the Board noted, is meant by the notion of a ‘basic lending arrangement’ in IFRS 9. Applying IFRS 9, if an entity revises its estimates of contractual cash flows, it makes a catch-up adjustment to adjust the gross carrying amount of a financial asset (or the amortised cost of a financial liability) measured at amortised cost.
14. As noted in paragraph 10, many respondents asserted that the accounting treatment for negative compensation should be the same as the accounting treatment for positive compensation. The staff acknowledge that the second eligibility condition creates asymmetry in the accounting treatment. However, such asymmetry is consistent with the Board’s intention as set out in the Basis for Conclusions on the ED because, as many respondents acknowledged, the

frequency of catch-up adjustments is likely to increase when a prepayment feature includes both negative compensation and positive compensation.

15. The staff acknowledge that the frequency of catch-up adjustments is not explicitly used as a determinative factor to assess whether particular contractual cash flows are SPPI. However, it forms part of the underlying thinking about when amortised cost provides useful information, which is directly related to the objective of the SPPI condition in IFRS 9—to identify instruments for which the effective interest method results in relevant and useful information¹. Mechanically, some may argue that amortised cost can work for any variability in cash flows via the catch-up adjustment mechanism. However, recognising frequent catch-up adjustments would likely not result in useful information about the instrument's future cash flows. As described in paragraph BC21 of the Basis for Conclusions on the ED, such frequent adjustments reduce the usefulness of the interest amounts that are allocated using the effective interest method and thus could suggest that fair value measurement would provide more useful information.
16. A prepayment feature is an example of a contractual term that can change the timing and the amount of contractual cash flows. As uncertainty about the amount and timing of contractual cash flows increases, eg as a result of a prepayment feature, the usefulness of amortised cost information to faithfully represent the likely actual cash flows decreases. Negative compensation increases uncertainty about the amount of contractual cash flows because, for example, if the borrower has the option to prepay, then the lender could receive *or* pay the compensation amount. The Board acknowledged that the proposals in the ED would expand the population of financial assets that are eligible for amortised cost measurement, and would result in financial assets with more uncertainty and variability in their contractual cash flows being measured at amortised cost. Accordingly, the Board's objective for the second eligibility condition was to limit the scope of the proposals so that financial assets are eligible for amortised cost measurement only if it is unlikely that prepayment, and specifically negative compensation, will actually occur.

¹ As noted in paragraph BC4.172 of Basis for Conclusions on IFRS 9

Is the second eligibility condition effective in restricting the scope?*The fair value of a prepayment feature and the probability of prepayment*

17. The staff think the second eligibility condition would, at least in some cases, achieve the Board's objective. That is because the fair value of the prepayment feature would consider the likelihood of prepayment occurring.
18. Some respondents asserted that if the prepayment amount includes compensation only for movements in the benchmark interest rate (as opposed to compensation for movements in the 'full interest rate', which would include consideration for other risks such credit risk and liquidity risk), then the fair value of such a prepayment feature would be more than insignificant, *even if the probability of prepayment is low*.
19. The staff agree that the fair value of a prepayment feature can be more than insignificant in such cases but it would depend on how likely it is that prepayment will occur. The fair value of the prepayment feature will consider the probability of prepayment occurring. If it is very unlikely that prepayment will occur, then the fair value of the prepayment feature will be insignificant, even if it has significant 'intrinsic value'. The staff therefore disagree that the fair value of a prepayment feature will *always* be more than insignificant even if the prepayment is unlikely. We note that this is consistent with the Board's objective, described in paragraph BC22 of the Basis for Conclusions on the ED, to restrict the scope of the amendments to financial assets that are not likely to be prepaid.
20. The same analysis would apply to some other examples provided by respondents who said that the second condition was unduly restrictive. For example, some respondents gave the example of a prepayment feature in which the amount of compensation payable by the borrower is capped whereas the amount payable by the lender is not. In such cases, the fair value of the prepayment feature at initial recognition may be more than insignificant due to the asymmetry in the amount of compensation payable by the two parties. The staff agree that may be the case, depending on the probability of prepayment occurring. If the fair value of such a prepayment feature is more than insignificant, that value would be, at least in part, due to the probability of prepayment occurring.

21. As another example, a respondent said that the fair value of a prepayment feature embedded in a long-term financial asset would be more than insignificant because the fair value of such a prepayment feature will reflect a higher ‘time value’. The staff acknowledge that the longer the prepayment period, the more likely it is that prepayment will occur (all else being equal) and, as a result, the fair value of the prepayment feature is likely to be higher compared to a short-term financial asset. This is consistent with the Board’s objective.

Financial assets acquired subsequent to their origination

22. The fair value of a prepayment feature embedded in a financial asset that is acquired subsequent to its origination may be more than insignificant if the relevant market interest rate has changed since origination. Some respondents said that they think it is inappropriate that such prepayable assets would not meet the second eligibility condition, particularly if the fair value of such prepayment features would have been insignificant when the financial asset was originated.
23. The staff note that an entity classifies a financial asset, which includes assessing its contractual cash flow characteristics, at the date when an entity *initially recognises* the financial asset. Consequently, it is possible for entities to reach different conclusions on whether the contractual cash flows of a particular financial asset are SPPI depending on when the respective entity initially recognises the asset. For example, a financial asset could be prepayable only during the first two years of its 10-year term. If an entity acquires the financial asset three years after the asset is originated (ie when the financial asset can no longer be prepaid), then the prepayment feature would be irrelevant to that entity when it performs the SPPI assessment. Accordingly, the staff thinks it is reasonable for a holder to conclude that a financial asset, which is acquired subsequent to its origination, does not meet the SPPI condition even if the same financial asset would have met that condition at origination.
24. In some cases, an entity may have paid a premium or received a discount to the contractual par amount when it acquires a prepayable financial asset because the fair value of the financial asset has changed since origination. If so, it is likely that such assets would be within the scope of paragraph B4.1.12 of IFRS 9. Applying paragraph B4.1.12(c), an entity would need to assess the fair value of

the prepayment feature at the date it initially recognises the financial asset. If the fair value of the prepayment feature is not insignificant, then such an asset must be measured at fair value through profit or loss.

Is the second eligibility condition effective in restricting the scope in the way the Board intended?

25. As noted in paragraph 16 of this paper and in paragraph BC22 of Basis for Conclusions on the ED, the objective of the second eligibility condition was to ensure that the scope of the amendments 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. In particular, the second eligibility condition seeks to limit the scope 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.
26. The staff acknowledge the concerns raised by some of the respondents who stated that the second eligibility condition does not always achieve the Board's objective as stated in paragraph 25. This can occur under various circumstances.
27. Firstly, the fair value of any such prepayment feature will reflect the fair value of reasonable *positive* compensation. In particular circumstances, it is also possible that the fair value of the prepayment feature may be more than insignificant largely (or entirely) due to such positive compensation. This outcome arguably would be inconsistent with the existing requirements in paragraph B4.1.11(b) of IFRS 9, which do not otherwise require a holder to assess the fair value of a prepayment feature that may give rise to reasonable positive compensation.
28. On the other hand, if the fair value attributable to positive compensation and negative compensation were equally significant, eg, because negative compensation is equally likely to arise as positive compensation, then the fair value of the prepayment feature as a whole could be insignificant as they offset each other. The resulting fair value in this case would no longer be a proxy for the probability of prepayment (and negative compensation) occurring and therefore may not restrict the instruments from being measured at amortised cost even if the probability of negative compensation arising is high.

29. Similar outcomes would arise when a financial asset can be prepaid at an amount close to its current fair value because the intrinsic value of such an option would be nil. Again the second eligibility condition, in such circumstances, would not prevent such an instrument from being measured at amortised cost even if the probability of negative compensation occurring is high.
30. Consistent with the discussion in paragraph BC22 of the Basis for Conclusions on the ED, the second eligibility condition was intended as a straightforward *proxy* to assess the likelihood of prepayment occurring; ie using fair value as an eligibility condition does not capture only probability. The Board used fair value in the same way in the existing exception in paragraph B4.1.12 of IFRS 9.
31. However, the staff acknowledge that when compared with the eligibility condition in B4.1.12(c), the second eligibility condition proposed in the ED may face more challenges in approximating the probability of prepayment. To explain, we simplify the fair value of a prepayment feature as two components: intrinsic value and probability of prepayment². The fair value of a prepayment feature may be insignificant because of insignificant intrinsic value, low probability of prepayment or both. Paragraph B4.1.12 applies only when a financial asset is acquired at a premium or a discount and is prepayable at the contractual par amount. In such cases, the difference between the purchase price and the prepayment amount will always result in some ‘intrinsic value’. As a result, the fair value of prepayment feature at initial recognition would likely be more than insignificant unless prepayment is unlikely to occur. On the other hand, for prepayment features with negative compensation, the existence or magnitude of intrinsic value is less certain (ie the financial asset would not have been originated or acquired at premium or discount). If the intrinsic value is insignificant, then the fair value could be insignificant irrespective of the likelihood that prepayment will occur. In such circumstances, assessing the fair value of the prepayment feature does not act as an effective proxy for assessing the probability of prepayment.

²It is commonly said that the value of an option is driven by two components, intrinsic value and time value. In simple terms, we can consider time value to represent the chances that the option will become in-the-money, and therefore will be exercised. In our simplified illustration above, we consider the time value as an approximation for the probability of exercise.

32. Consequently, we acknowledge that there is evidence that the second eligibility condition does not achieve the Board's objective in some circumstances.

Can the second eligibility condition be operationalised?

33. The staff notes that there were mixed views on the difficulty of assessing whether the fair value of a prepayment feature is insignificant when the entity initially recognised the financial asset:

- (a) Some observed that determining the fair value of the prepayment feature would be difficult. A few noted that the added cost and complexity of applying the second eligibility condition would outweigh any benefit that it provides; and
- (b) A few preparers and industry bodies said that, although they think the second eligibility condition is unnecessary, it can be operationalised.

34. As noted in paragraph BC8 of the Basis for Conclusions on the ED, the amendments will add complexity to IFRS 9. The staff thinks that the level of cost and effort required to apply the second eligibility condition will vary among entities, depending on many factors such as the data that an entity has available about any prepayment features that may result in negative compensation. Furthermore, as discussed above in paragraph 30 of this paper, the existing exception in paragraph B4.1.12 requires an entity to assess the fair value of particular prepayment features and we are not aware of any concerns about the operability of the eligibility condition in paragraph B4.1.12(c), or undue difficulty or complexity in its application.

Alternatives considered

35. In the light of the challenges discussed in paragraphs 26—32, the staff considered using one of the following alternatives as an eligibility condition in place of the second eligibility condition proposed in the ED:
- (a) Insignificant or low *probability* of negative compensation occurring;
 - (b) Insignificant or low *probability* of prepayment occurring;

- (c) Insignificant *fair value* of a prepayment feature *attributable to negative compensation*; and
- (d) *Intrinsic value* of the prepayment feature.

Probability-based condition

- 36. The staff acknowledge that a probability-based condition arguably could better achieve the board's objective because it would result in a more precise identification of the population of financial assets to be in scope of the amendments. That is, it would directly identify (rather than act as a proxy) those financial assets where the probability of prepayment, or the probability of negative compensation, is low.
- 37. Those respondents who suggested a probability-based assessment said that prepayment is often a business decision rather than a decision triggered by economic incentives such as fair value gains and, therefore, they argued that fair value is not a good proxy for assessing the likelihood of prepayment. The staff acknowledge that the fair value of the prepayment feature at a particular point in time may not trigger prepayment. However, as discussed above in paragraph 17 of this paper, the staff think the fair value at initial recognition will indeed reflect the probability of prepayment, ie the fair value of the prepayment feature reflects probability of exercise and intrinsic value.
- 38. The staff note that applying IFRS 9, an entity is not permitted to take into account the probability that the future event will occur, unless the contingent feature is not genuine³. Creating a probability-based condition would introduce a new type of assessment into IFRS 9 and it would also give rise to additional data requirements. Entities will need to track separately the occurrence of negative compensation in order to be able to determine its probability to apply the test.

Fair value attributable to negative compensation

- 39. Determining the fair value of a prepayment feature specifically attributable to negative compensation could be a more precise way to restrict the scope of the amendments consistently with the Board's objective compared to determining the

³ Paragraph BC4.189

fair value of the entire prepayment feature. However, to obtain such a measure, an entity would have to know the probability of negative compensation occurring at each possible prepayment date, as well as the probability of prepayment occurring. Such an analysis would require the entity to look at a prepayment feature as two separate parts, the negative compensation part and the positive compensation part, which would be akin to ‘componentisation’ of a derivative contract. We note that IFRS 9 does not require or permit componentisation of derivatives. Moreover, we expect that such componentisation would not be straightforward in most cases and we expect there would be multiple possible ways to do it. 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 and could be onerous for the entities to implement, especially at this late stage in their IFRS 9 implementation activities.

Intrinsic value of the prepayment feature

40. By focusing only on the intrinsic value of the prepayment feature, the probability of prepayment would not be considered. This would seem inconsistent with the Board’s objective of limiting 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 negative compensation, will occur.

Final observations on the alternatives identified

41. The staff acknowledge that the second eligibility condition proposed in the ED aims to be a *proxy* for a probability-based condition without the challenges involved in a pure probability assessment. Because it is a proxy solution, we acknowledge that there are shortcomings as discussed in paragraphs 26—32.
42. However, as discussed above, we think that all of the alternatives also have challenges and limitations. Moreover, 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.

Final observations on the second eligibility condition

43. As discussed in paragraphs 26—32, the second eligibility condition was intended as a straightforward way to assess the likelihood of prepayment occurring (in the same way that the condition in paragraph B4.1.12(c) of IFRS 9 is a proxy) and, as such a proxy, has its shortcomings.
44. On the basis of the evidence obtained through the feedback on the ED, the staff think that the second eligibility condition would be effective in narrowing the scope of the amendments consistent with the Board’s objective in some circumstances, especially when the probability of prepayment is high. The staff notes that many respondents said that, in their experience, financial assets that contain prepayment features with negative compensation are not prepaid very frequently. Although there may have been limited prepayments in recent years, if such prepayments were to increase in frequency in the future, the second eligibility condition may become more effective.
45. However, as discussed above in paragraphs 26—32, the staff acknowledge the concern that the second eligibility condition may be ineffective in some circumstances. Overall, the staff acknowledge that the evidence obtained about the effectiveness of the second eligibility condition is limited, ie arguably the second eligibility condition would restrict the scope in a way that is consistent with the Board’s objective in only some circumstances.
46. The staff note that without the second eligibility condition, the scope of the amendments would rely entirely on the effectiveness of the first eligibility condition. That is discussed below in paragraphs 63—65.

Implications of retaining the second eligibility condition

47. We think there are some additional matters that need to be discussed *if* the Board decides to retain the second eligibility condition proposed in the ED.
48. Specifically, we think the Board would need to make decisions on the following issues:
- (a) refining the description of ‘negative compensation’;

- (b) the interaction between the existing exception in B4.1.12 and the proposed amendments; and
- (c) the transition provision proposed in the ED.

49. If the Board decides to remove the second eligibility condition, we think these issues are not relevant, as discussed below.

Refining the description of 'negative compensation'

50. As discussed in paragraph 14 of this paper, the second eligibility condition creates a difference between the requirements for reasonable *positive* compensation and the requirements for reasonable *negative* compensation. Therefore, it is important to clearly distinguish between those two populations so that preparers know which requirements to apply to a particular instrument. (In contrast, if the Board decides to remove the second eligibility condition, then those two populations would be treated in the same manner so it is arguably less important to define the difference.)

51. Paragraph B4.1.12A(a) of the ED said that negative compensation arises in circumstances when :

[...] 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...

52. A respondent raised an issue about that description. Specifically, the respondent noted that the description does not seem to consider the case where the only triggering event is one that is not caused by either party (ie early termination is caused by an external event such as a change in law or regulation). The respondent said that it is unclear how to assess a prepayment amount that includes compensation for the early termination of the contract in those circumstances; ie whether that compensation amount is considered to be 'positive' or 'negative'. On one hand, it does not seem to be accommodated by the description of negative compensation in the proposed amendments because neither of the parties 'chose to terminate the contract early, or otherwise caused the early termination to occur'. But, on the other hand, it does not seem to be accommodated by the existing requirements in B4.1.11(b) for positive compensation because, for example, the lender could be *forced* to terminate the contract early (ie termination is not within

the lender's control) and accept a prepayment amount that is less than unpaid amounts of principal and interest such that it would not recover its investment. Therefore, it is unclear how such an instrument would be accounted for under IFRS 9 or the amendments.

53. Consequently, if the Board decides to retain the second eligibility condition, then we think the description of negative compensation for the early termination of the contract needs to be clarified to address such circumstances. The staff considered the following alternatives:

- (a) If the early termination of the contract is caused by a factor beyond the control of both parties, then any resulting compensation for the early termination of the contract is considered to be 'positive compensation', ie within the scope of paragraph B4.1.11(b); or
- (b) If the early termination is caused by a factor beyond the control of both parties, then any resulting compensation for the early termination of the contract is considered to be 'negative compensation', ie within the scope of the amendments.

54. The staff note that the wording in paragraphs BC15 and BC20 of the Basis for Conclusions on the ED could indicate that negative compensation arises whenever a party to the contract is *forced* to pay compensation for the early termination of the contract; ie paying such an amount is out of its control. Arguably a party can be forced by the actions of the other party *or* forced by circumstances that are outside both parties' control. That wording would seem to support the alternative described in paragraph 53(b) above.

The interaction between the existing exception in B4.1.12 and the proposed amendments

55. If the Board decides to retain the second eligibility condition, then we think it is necessary to discuss the interaction between the existing exception in paragraph B4.1.12 and the proposed amendments, ie whether a financial asset that contains a prepayment feature with negative compensation is eligible for the exception in paragraph B4.1.12.

56. 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 said it is unclear why those exceptions should be mutually exclusive and expressed the view that the proposed amendments should apply to financial assets that are originated (or acquired) at a discount or premium.
57. The staff note that paragraph BC19 in the Basis for Conclusions on the ED was intended only to observe that, as drafted, those two exceptions are mutually exclusive because a single financial instrument could not meet the conditions for both exceptions. In its deliberations leading to the ED, the Board did not consider whether a single financial asset *should* be able to meet both exceptions.
58. 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 and, as discussed in paragraph BC19 of the Basis for Conclusions on the ED, would allow a financial asset to 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.
59. However, we note that the exception in paragraph B4.1.12 applies only to financial assets that are 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.
60. If the Board decides to remove the second eligibility condition, then we think a logical consequence of that decision would be that paragraph B4.1.12 would accommodate negative compensation, unless the Board specifically decides that it should not. That is because, if the Board removes the second condition, then the accounting for negative compensation and positive compensation would be

aligned. We think that symmetry would equally apply to the condition in paragraph B4.1.12(b).

Transition provision and related disclosures specific to the second eligibility condition

61. Finally, if the Board decides to retain the second eligibility condition, then we think the Board would need to decide whether to confirm the related transition provision and the associated disclosures proposed in the ED. In the ED, the Board proposed that when an entity first applies the amendments, if it is impracticable for an entity to assess the second eligibility condition on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, then the entity would assess the contractual cash flow characteristics on the basis of the facts and circumstances that existed at the initial recognition of the financial asset without taking into account the proposed exception. If the entity applies that transition provision, then the ED proposed that the entity provide particular disclosures.
62. Most of those respondents who did not support the second eligibility condition noted that the specific transition provision would be unnecessary if that condition were removed. Otherwise, most respondents agreed with the transition provision and related disclosures. Our view therefore remains unchanged.

Discussion in the Basis for Conclusions on the application of the first eligibility condition

63. As described above in paragraph 5 of this paper, although they agreed with the first eligibility condition, many respondents expressed concern that the Basis for Conclusions on the ED seems to interpret or provide additional guidance on the existing requirements in IFRS 9; in particular on the meaning of ‘reasonable compensation for the early termination of the contract’. Respondents said the amendments should not contain such interpretative guidance because that guidance is unnecessary, is outside the scope of the amendments and could have unintended consequences on the accounting for other instruments that the ED was not intended to address. The respondents were specifically concerned about the following statements in the Basis for Conclusions:

BC 18 [...] The Board concluded that a fair value amount is not reasonable compensation *for the early termination of the contract*.

[...] 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.

64. We think the notion of ‘reasonable additional compensation for early termination of the contract’ is important to the application of the first eligibility condition. The staff think that it is relevant to understanding the Board’s intention for how the first eligibility condition would be applied, and specifically, to understanding the types of prepayment amounts that the Board expected to meet (and not meet) that condition. As long as the Board confirms the first eligibility condition, the staff thinks that condition should be reinforced by retaining the explanation in the Basis of Conclusions. That would be the case regardless of the Board’s decision on retaining or deleting the second eligibility condition, although such explanation would become particularly important if the Board decides to remove the second eligibility condition because, in that case, the scope of the amendments would depend entirely on the first eligibility condition. We think the explanation in the Basis for Conclusions related to the notion of ‘reasonable compensation for the early termination of the contract’ would be critical in order to support the consistent and appropriate application of the first eligibility condition and strengthen entities’ understanding of the scope of the amendments.
65. Having said that, the staff acknowledge that the wording in the Basis for Conclusion on the ED may have been too rigid or absolute. 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 fair value prepayment amount will approximate unpaid amounts of principal and interest, and compensation for only changes in the market benchmark interest rate. However,

that does not mean that a prepayment amount that reflects the instrument's current fair value is *always* consistent with a notion 'reasonable compensation for the early termination of a contract'. We think that 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.

Staff recommendation

66. Staff recommendation and the questions for the Board on the issues discussed in this agenda paper are discussed further in Agenda Paper 3C as part of the package of interrelated recommendations for finalising the amendments to IFRS 9.