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IFRS Developments

IASB proposes amendment to IFRS 9 on measuring instruments with negative compensation prepayment features

What you need to know

- The ED proposes that debt instruments with prepayment features that give rise to compensation being paid to the party triggering the option would be eligible to be measured at amortised cost or fair value through other comprehensive income in certain circumstances.
- The amendment also clarifies that prepayment of a debt instrument at its current fair value would not be regarded as reasonable compensation. This would also apply to instruments where only the lender is compensated for early termination.

Highlights

On 21 April 2017, the International Accounting Standards Board (IASB) issued exposure draft (ED) *Prepayment Features with Negative Compensation (Proposed amendments to IFRS 9*).

The ED proposes a narrow-scope amendment to IFRS 9 *Financial Instruments* (IFRS 9) so that certain financial assets with an early prepayment feature that can give rise to compensation to the party triggering the option could be eligible to be measured at amortised cost or at fair value through other comprehensive income.

Similar to the effective date of IFRS 9, the proposed effective date for this amendment is for annual periods beginning on or after 1 January 2018 with retrospective application required. Earlier application is permitted, if IFRS 9 is also applied early in its entirety.

Background

Under IFRS 9 a debt instrument can be measured at amortised cost or at fair value through other comprehensive income, provided that the contractual cash flows are 'solely payments of principal and interest on the principal amount outstanding' (the SPPI criterion) and the instrument is held within the appropriate business model for that classification.

IFRS 9[1] addresses whether contractual terms that permit the early termination of contracts meet the SPPI criterion and states that such options meet the SPPI criterion only 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. This is generally interpreted as meaning that in order to meet the SPPI criterion, the compensation or prepayment penalty must be paid by the party exercising the option to the other party, otherwise the payment will not be compensation.

The IFRS Interpretations Committee (IFRS IC) was recently asked whether a debt instrument would meet the SPPI criterion if its contractual terms permitted the borrower to prepay the instrument at a variable amount that could be more or less than the unpaid amounts of principal and interest. In particular, the IFRS IC was asked to consider instruments with features where the debt could be prepaid at an amount that reflected:

- The remaining contractual cash flows discounted at the current market rate of interest (symmetrical prepayment)

  Or

- Prepaid at the instrument's current fair value (prepayment at fair value)

If the current market interest rate is higher than the effective interest rate of the debt instrument, then a prepayment by the borrower will be less than the unpaid amounts of principal and interest. Therefore, this will lead to the lender effectively compensating the borrower for the increase in interest rate even if the borrower chooses to prepay the debt instrument.

The IFRS IC confirmed that an outcome in which the party choosing to terminate the contract receives an amount (instead of pays an amount, i.e., there is 'negative compensation') is inconsistent with IFRS 9.[2] However, the IFRS IC noted that, despite the payment of negative compensation, the amortised cost measurement could provide useful information for some financial assets with such prepayment features.

Symmetrical prepayment

The IASB is concerned that symmetrical prepayment features are prevalent in a number of jurisdictions where they are attached to corporate loans and retail mortgages which would otherwise be considered 'simple' debt instruments. Consequently, the IASB is proposing a narrow scope amendment such that certain instruments which have symmetrical prepayment options, but would otherwise be regarded as being simple debt instruments, could meet the SPPI criterion.

The amendment proposes that such debt instruments would meet the SPPI criterion if they meet two conditions:

- The prepayment amount is inconsistent with IFRS 9[3] only because the party that chooses to terminate the contract early may receive reasonable additional compensation for doing so
- The fair value of the prepayment feature is insignificant when the entity initially recognises the transaction

The second of these two conditions has been inserted to limit the scope of the amendment because the IASB is concerned that the amendment could otherwise result in the too frequent application of 'catch-up adjustments' as required under IFRS 9.[4] This paragraph requires the carrying amount of a financial asset to be adjusted to reflect revisions to estimates of contractual cash flows through profit or loss, while keeping the original effective interest rate unchanged (this is the same as the adjustment in IAS 39 *Financial Instruments: Recognition and Measurement*).[5] The IASB

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[1] IFRS 9 B4.1.11(b)
[2] IFRS 9 B4.1.11(b)
[3] IFRS 9 B4.1.11(b)
[4] IFRS 9 B5.4.6
[5] IAS 39 *Financial Instruments: Recognition and Measurement,* Paragraph AG8

considers that significantly increasing the frequency of such catch-up adjustments is inconsistent with the objective of the effective interest method as a simple technique to allocate interest over the relevant time period.

The second condition is therefore designed to limit the scope of the amendment so that it only applies when it is unlikely that prepayment (and thus, 'negative compensation') will occur. Insignificant fair value (including time value) is used as a straightforward way to reflect the unlikely exercise of the prepayment option, as a prepayment option which has insignificant fair value is not expected to be exercised.

The IASB notes in the Basis for Conclusions to the ED that instruments with prepayment features that compensate the parties to the contract only for changes in the relevant interest rate would not necessarily have an insignificant fair value. Such prepayment amounts are different from prepayments that equal the instrument's current fair value, because they reflect compensation for change in only part of an interest rate and so could have a fair value that is more than insignificant unless the prepayment is unlikely to occur.

Further, the Basis for Conclusions stresses that the amendment does not allow a financial instrument to meet the conditions for both the new exception *and* the existing exception in the standard.[6] Hence, any instrument acquired or originated at a premium or discount to the par amount, but which can be prepaid at any time at par plus accrued interest *and* the prepayment amount may include negative compensation, would be measured at fair value though profit or loss.

The ED proposes that if it is impracticable for an entity to determine the fair value of the prepyament option at initial recognition, it must assess the SPPI features of the loan without taking into account the proposed exception.

How we see it

The determination of whether the fair value of the prepayment option is insignificant would be based on a comparison with the fair value of such an instrument without such an option.

The fair value of the option should reflect any factors that a market participant would take into account in pricing the option, including any constraints on its exercise and the borrowers' behaviour. For instance, the fair value of the prepayment option is likely to be less significant for a mortgage loan if the borrower can only prepay with a two-way break clause in the event of moving house.

The fair value of the prepayment option will also be small when the prepayment amount is based on the instrument's fair value. But this would not meet the SPPI criteria, as set out in the next section.

Given that the exception will not apply when the fair value of the prepayment option is more than insignificant or where the instrument is acquired or originated at a premium or discount, consistent with the IASB's intent, the exception would have limited application.

Prepayment at fair value

The Basis for Conclusions to the ED is clear that compensation that reflects the effect of the change in the relevant market interest rate (representing 'lost interest') does not introduce any contractual cash flow amounts that are different from the cash flows amounts accommodated by IFRS 9.[7]

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[6] IFRS 9 B.4.1.12

[7] IFRS 9 B.4.1.11(b)

In contrast, the Basis for Conclusions states that a prepayment option that allows the borrower to prepay the instrument at its current fair value is inconsistent with a basic lending arrangement. This is because, apart from potentially giving rise to negative compensation, it also exposes the holder to changes in the fair value of the instrument and the contractual cash flows stemming from such exposures are not SPPI. Such instruments would therefore be measured at fair value through profit or loss.

The IASB also states in the Basis for Conclusions that an asset that is prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument could also expose the holder to factors that result in contractual cash flows that are not SPPI.

How we see it

The observations made in the Basis for Conclusions have consequences for instruments that are prepayable at their current fair value, whether the prepayment amounts are symmetrical or not. Even if there is no negative compensation, an instrument prepayable at fair value must be recorded at fair value through profit or loss.

The ED states that an instrument would still qualify to be recorded at amortised cost if the prepayment amount reflects the net present value of the change in the relevant market interest rate, Although the 'benchmark rate' is cited as an example, this term would ordinarily include a premium for credit risk and liquidity (as reflected in other parts of the Basis for Conclusions, which refers to the return on a similar contract) and the intended meaning is not clear. Given that it is the market rate that determines an instrument's fair value, it is not yet clear to us why the IASB belives that an instrument containing an option that allows the borrower to repay at the current fair value would not be SPPI.

In contrast, the Basis for Conclusions notes that a financial asset that is prepayable at an amount that includes the fair value to terminate an associated hedging instrument may still be classified as amortised cost if the prepayment feature is consistent with a basic lending arrangement (as defined in IFRS 9).[8] It appears that the IASB's main concern is with a hedging instrument whose fair value may reflect factors other than just market rates of interest, including the creditworthiness of the two parties to the contract. In which case, such a prepayment option is most likely to meet the SPPI criterion if the hedging instrument is a fully collateralised interest rate swap.

Next steps

The comment period closes on 24 May 2017. We encourage stakeholders to provide feedback to the IASB on the proposed amendments.

[8] IFRS 9 B4.1.11(b)

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ED None