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Prepayment Features with Negative Compensation - Towards a DEA - Appendix I
Issues paper

Background of the Amendments

1 After IFRS 9 *Financial Instruments* was issued, the IFRS Interpretations Committee (the Interpretations Committee) received a submission asking how to classify particular prepayable financial assets applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower to prepay the instrument at an amount that could be more or less than unpaid amounts of principal and interest, such as at the instrument's current fair value or at an amount that reflects the remaining contractual cash flows discounted at the current market interest rate.

2 As a result of such a contractual prepayment feature, the lender could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. Such a prepayment amount would, in effect, include an amount that reflects a payment to the borrower by the lender (instead of compensation from the borrower to the lender) even though the borrower chose to terminate the contract early. This is referred to as negative compensation.

The issue and how it has been addressed

3 The Interpretations Committee concluded that, applying IFRS 9, those contractual cash flows are not solely payments of principal and interest, and therefore the financial assets would be measured at fair value through profit or loss.

4 However, Interpretations Committee members suggested that the IASB consider whether using amortised cost measurement could provide useful information about particular financial assets with such prepayment features, and if so, whether the requirements in IFRS 9 should be changed in this respect.

5 In the light of the Interpretations Committee's recommendation and similar concerns raised by banks and their representative bodies in response to the Interpretations Committee's discussion, the IASB decided to propose a change to IFRS 9 for 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 result in negative compensation. Applying the proposals, such financial assets would be eligible to be measured at amortised cost or at fair value through other comprehensive income, subject to the assessment of the business model in which they are held.

What has changed?

6 The Amendments propose a change to IFRS 9 for particular 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.

7 Specifically, for financial instruments which contain a prepayment amount that may result in negative compensation, the Amendments propose that, in applying paragraphs B4.1.11(b) and B4.1.12(b) of IFRS 9, such a financial asset would be eligible to be measured at amortised cost or at fair value through other comprehensive income, subject to the assessment of the business model in which it is held.

When do the Amendments become effective?

8 An entity shall apply the Amendments for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

9 The Amendments shall be applied retrospectively, except as specified below.

10 When an entity first applies the Amendments at the same time it first applies IFRS 9, then the entity applies the transition requirements of IFRS 9. In contrast, when an entity first applies the Amendments after it first applies IFRS 9, specific transition requirements are applicable that are necessary for applying the Amendments.

11 If an entity applies the Amendments for the first time after it applies IFRS 9 then the entity is permitted to newly designate and is required to revoke its previous designation of, a financial asset or a financial liability at the date of initial application of the Amendments only to the extent that a new accounting mismatch is created, or a previous accounting mismatch no longer exist, as a result of the Amendments.

12 An entity is not required to restate prior periods to reflect the effect of the Amendments, and can choose to do so only if it is possible without the use of hindsight and if the restated financial statements reflect all the requirements of IFRS 9.

13 Finally, disclosures about transition are included. i.e. in the reporting period that includes the date of initial application of the Amendments, an entity is required to disclose the following information for each class of financial assets and financial liabilities that were affected by the Amendments:

(a) the previous measurement category and carrying amount determined in immediately before taking into account the effect of the Amendments;

(b) the new measurement category and carrying amount determined in accordance with the Amendments;

(c) the carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated under the fair value option but are no longer so designated; and

(d) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.