EFRAG

European Financial Reporting Advisory Group

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IFRS 9 Amendments - Symmetric Prepayment options Issues Paper

Objective

1 The objective of this session is to provide an overview of the IASB tentative decisions on the forthcoming narrow-scope amendment to IFRS 9 *Financial Instruments* related to symmetric prepayment options and obtain EFRAG CFSS members' initial views on these decisions.

Background

2 For a debt instrument to be eligible for measurement at amortised cost or at fair value through other comprehensive income ('FVOCI'), IFRS 9 requires both of the following conditions to be met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows (amortised cost) or whose objective is achieved by both collecting contractual cash flows and selling financial assets (FVOCI); and

(b) the contractual cash flows meet the 'solely payments of principal and interest' ('SPPI') criterion[1].

3 For contractual terms that permit the borrower to prepay a debt instrument (or permit the lender to demand prepayment from the borrower before maturity), paragraph B4.1.11 (b) of IFRS 9 states that a prepayment option 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.

4 When applying the effective interest method for amortised cost measurement, the entity would consider at initial recognition the contractual cash flows arising from a prepayment feature when it estimates the future cash flows and determines the effective interest rate. Subsequently, the entity would make a catch-up adjustment through profit or loss if it revises its estimated cash flows, including any revisions relating to the exercise of the prepayment option.

5 In paragraphs BC4.22-4.26 of the Basis for Conclusions on IFRS 9, the IASB noted that the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal amount outstanding. According to paragraph B4.1.7A of the Appendix B (Application guidance) to IFRS 9, contractual cash flows that are solely payments of principal and interest are consistent with a basic lending agreement. In a basic lending agreement, the most significant

[1] Throughout the paper, it is assumed 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 FVOCI, where amortised cost information is presented in profit or loss).

elements of interest are usually the consideration of the time value of money and credit risk. However, in such an arrangement, interest can also include consideration for other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs). In addition, interest can include a profit margin that is consistent with a basic lending agreement.

Description of the issue

How did the issue arise?

6 The IFRS Interpretations Committee ('IFRS IC') received a request to clarify whether a debt instrument could have contractual cash flows that meet the SPPI criterion 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'.

7 According to the submission, a 'symmetric make whole prepayment option' allows the borrower to prepay the debt instrument at an amount that reflects the remaining contractual cash flows of the instrument discounted at a current market interest rate. A 'fair value prepayment option' allows the borrower to prepay the debt instrument at its current fair value. The submission observes that the fair value prepayment amount will correspond to a discounted value of the remaining contractual cash flows at a current rate that reflects a current benchmark interest rate, a current credit spread for the borrower, and potentially a liquidity premium or profit margin.

What is the difference between a symmetric and an asymmetric prepayment option?

An asymmetric prepayment option

8 Both the borrower and the lender have the option to terminate the contract before maturity. The party exercising the option must compensate the other party for the effect of any change in market interest rate since the asset was initially recognised.

Who terminates early?	**Market interest rates?**	**Who compensates?**
Borrower	Have decreased ⇩	Borrower compensates the lender for 'lost interest' over the remaining term of the asset[2]
Borrower	Have increased ⇧ or remained the same	No additional amount is due
Lender	Have increased ⇧	Lender compensates the borrower for the effect of change in interest rates over the remaining term of the asset
Lender	Have decreased ⇩ or remained the same	No additional amount is due

A symmetric prepayment option

9 As before, both the borrower and the lender have the option to terminate the contract before maturity, but the additional payment amount does not depend on which party chooses to exercise its option to terminate early.

[2] The EFRAG Secretariat acknowledges that local consumer legislation may limit that compensation.

Who terminates early?	**Market interest rates?**	**Who compensates?**
Borrower or Lender	Have decreased ⇩	Borrower compensates the lender for 'lost interest' over the remaining term of the asset
Borrower or Lender	Have increased ⇧	Lender compensates the borrower for the effect of change in interest rates over the remaining term of the asset

10 In other words, an asset with a symmetric prepayment option could have the result that the party that chooses the early termination of the contract may effectively receive a payment from the other party, rather than pay compensation to the other party (this is usually referred to as 'negative compensation').

IFRS IC discussions

11 The issue was first discussed at the November 2016 IFRS IC meeting. Most IFRS IC members were of the view that paragraph B4.1.11 (b) of IFRS 9 refers only to instruments for which the party exercising the option to terminate the contract compensates, or pays a prepayment penalty to, the other party (asymmetric prepayment options as described above).

12 In the instruments described in the submission to the IFRS IC, the lender could be forced to settle the contract and not recover its investment, or the borrower could be forced to settle the contract and repay more that in owes (symmetric prepayment options as described above).

13 Consequently, most IFRS IC members were of the view that the prepayment options described in the submission did not meet the requirements in paragraph B4.1.11 (b) of IFRS 9 and, thus, an instrument with such a contractual characteristic would not meet the SPPI condition.

14 The IFRS IC suggested that the IASB considers 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 ones described in the submission.

How the IASB plans to address the issue?

15 At its January 2017 meeting, the IASB tentatively decided to propose a narrow-scope amendment to IFRS 9 so that a financial asset with a symmetric prepayment option would be eligible to be measured at amortised cost, or at FVOCI (subject to the business model condition) if the following conditions are met:

(a) the financial asset would otherwise meet the requirements in paragraph B4.1.11 (b) of IFRS 9, but does not meet them, only as a result of the symmetric nature of the prepayment option; and

(b) at the initial recognition of the financial asset, the fair value of the symmetric prepayment option is insignificant.

16 The IASB believes 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 these particular symmetric prepayment features.

17 The IASB stressed that the proposed amendment is meant to be a very narrow exception to the general rule and that the prepayment option must first meet the 'reasonable additional compensation' criterion for lost long-term interest (and not for other risks) before being assessed for qualification for the proposed exception.

18 The IASB added the additional eligibility condition mentioned in paragraph 15(b) above to ensure that the scope of the proposed exception is sufficiently narrow and to avoid extending the amortised cost measurement too broadly. In that way, according to the IASB staff, if it is likely that non-SPPI cash flows will occur, then this additional eligibility condition ensures that these financial assets are not measured at amortised cost.

19 The IASB also tentatively decided to propose an effective date same as IFRS 9 (i.e. annual periods beginning on or after 1 January 2018), but tentatively agreed to include a question in the forthcoming Exposure Draft ('ED') about whether a later effective date, with early application permitted, would be more appropriate.

20 The IASB aims to publish the ED by the end of April 2017 with a 30-day comment period, so that a final amendment can be issued by the end of October 2017.

EFRAG Secretariat analysis

Do these features occur often in Europe?

21 At this stage, the EFRAG Secretariat does not have evidence of the significance and frequency of the issue in Europe.

22 The IFRS IC paper of November 2016 notes that symmetric make whole or fair value prepayment options are common features in otherwise vanilla lending instruments, however does not distinguish between the two. Because of the narrow-scope of the proposals, the EFRAG Secretariat notes it is relevant to identify which of the types of symmetric prepayment options occurs more often. As only the symmetric make whole prepayment options will be addressed by the proposals (in contrast to the fair value prepayment options), knowing whether they occur often may provide information about the need to open up a standard less than a year before its implementation.

Opportune for changing IFRS 9 at this moment?

23 The IASB decided to add a project on financial assets with symmetric 'make-whole' prepayment options to its agenda almost one year before IFRS 9 becomes effective. Opening IFRS 9 at that stage, may raise questions from constituents on why other IFRS 9 issues are not also being considered by the IASB.

Negative compensation for termination of the contract

24 At the December 2016 meeting, the IASB Board agreed with IFRS IC members that it would be inappropriate to measure all financial assets with symmetric 'make whole' prepayment options at amortised cost and noted that the scope of any proposed exception must be narrow and being 'surgically precise'.

25 According to the IASB staff, when the prepayment amount would fail the existing requirements under IFRS 9 for asymmetric prepayment options, then it will also fail the proposed exception. Also, a financial asset that is prepayable at fair value does not meet the existing requirements under IFRS 9 for asymmetric prepayment options as the prepayment amount reflects many factors unrelated to the simple notion of compensating for interest rate changes due to the early termination of the contract.

26 Hence, the proposed exception would only be valid for symmetric prepayment options that change the sign of the compensation amount; since IFRS 9 allows for an amortised cost measurement for a positive compensation amount, then the proposed exception would accommodate the same negative compensation amount.

27 The EFRAG Secretariat assesses that the prepayment option is described as delivering reasonable additional compensation for early termination of the contract. So it is not identified as being interest, rather a proxy for this. This conclusion may

have knock-on effects on the presentation of the identified cash flows (see paragraphs 31 and 32 below).

Use of amortised cost and fair value

28 EFRAG stated in its endorsement advice letter to the European Commission regarding the endorsement of IFRS 9, that amortised cost generally provides relevant information in relation to financial assets that have solely payments of principal and interest. The contractual cash flow test excludes instruments with contractual features giving rise to exposure to risks or fluctuations unrelated to a basic lending agreement, such as leverage or changes in equity prices or commodity prices.

29 EFRAG also mentioned that for debt instruments not passing the cash flow characteristics, fair value is a better predictor of future net cash inflows for these assets than amortised cost. The cash flows of these instruments are generally less predictable and thus, amortised cost provides a less relevant representation of future cash flows.

30 EFRAG has not assessed make-whole prepayment options when writing the IFRS 9 endorsement advice. Consequently, it is not clear at this moment whether such contractual features would tie in with the analysis above.

Presentation

31 The question arises on how payment of such an amount would have to be presented. In this regard, the EFRAG Secretariat recalls that the IFRS IC, at its January 2015 meeting, noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue*. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue, but in an appropriate expense classification.

32 The EFRAG Secretariat assesses that the negative compensation for early termination could also be seen as an expense and thus not as (negative) interest revenue.

Timeline

33 Regarding the expected proposed effective date of 1 January 2018, we note that the IASB timeline mentioned above will not allow an endorsement in Europe before the end of 2017, so endorsement may have to foresee retroactive application when being applied at a later effective date.

Questions for EFRAG TEG-CFSS

34 Are financial instruments with symmetric prepayment options common in EFRAG TEG-CFSS members' respective jurisdiction? Please provide examples (industry, whether they originate from legal/regulatory requirements or from common market practices, etc.). In doing so, please distinguish between symmetric make whole prepayment options and fair value prepayment options.

35 Does EFRAG TEG-CFSS agree with the IASB's view that classifying instruments with the symmetric make whole prepayment options described above in the amortised cost category, provides useful information?

36 Considering that an endorsement before the end of 2017 is unlikely, would you support an effective date later than 1 January 2018 but with retrospective application?

37 Does EFRAG TEG-CFSS have any other comments at this stage?

Agenda papers

38 In addition to this paper, agenda paper 08-02 *ASAF agenda paper 07 IFRS 9 Symmetric Prepayment Options - for background only – EFRAG TEG-CFSS 17-02-22* has been provided for this session.