

Financial instruments

IFRS Newsletter



“A narrow-scope exception for symmetric prepayment options may be welcomed by preparers but could also impact accounting for other prepayment features.”

– Chris Spall
KPMG’s global IFRS financial instruments leader

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The future of financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the IASB’s discussions in January 2017 on its project on IFRS 9 *Financial Instruments* regarding financial assets with symmetric ‘make-whole’ prepayment options (the ‘symmetric prepayment options project’).

The IASB has started its discussions on the classification under IFRS 9 of financial assets with symmetric ‘make-whole’ prepayment options, having agreed in December 2016 to add a narrow-scope project to its agenda.

Highlights

At its January meeting, the Board discussed a possible narrow exception to IFRS 9 that would allow particular financial assets with symmetric make-whole prepayment options to be eligible for measurement at amortised cost or at fair value through other comprehensive income (FVOCI) – depending on the business model.

The next steps for the project will be to:

- finish deliberations on the proposed exception; and
- publish an exposure draft in April 2017.

The Board aims to issue a final amendment in the fourth quarter of 2017 – i.e. before IFRS 9 becomes effective.

The FICE and macro hedge accounting projects were not discussed during the January meeting.

At the same meeting, the staff informed the Board that it should expect sweep issues from the fatal flaw review of IFRS 17 *Insurance Contracts* to be discussed at the February meeting. As a result, the staff now expect to publish the final insurance contracts standard in May 2017.

Symmetric prepayment options

The Board discussed an amendment to IFRS 9 to allow particular financial assets with symmetric prepayment options to be eligible for measurement at amortised cost, or at FVOCI.

The story so far...

For a debt instrument to be eligible for measurement at amortised cost or at FVOCI, IFRS 9 requires the contractual cash flows to meet the 'solely payments of principal and interest' (SPPI) criterion.

For contractual terms that permit the borrower to prepay a debt instrument (or permit the lender to put a debt instrument back to the borrower before maturity), IFRS 9 states that the contractual cash flows meet the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may include reasonable additional compensation for early termination of the contract.

In November 2016, the IFRS Interpretations Committee (the committee) discussed the classification of debt instruments that include symmetric 'make-whole' prepayment options or fair value prepayment options. Most committee members believed that such debt instruments fail to meet the SPPI criterion. This is because the borrower can choose to prepay and the lender can be forced to accept less than the amount of outstanding principal and interest. They believed that the SPPI criterion accommodates only instruments for which the party exercising its option to terminate the contract compensates, or pays a prepayment penalty to, the other party.

In November 2016, the committee suggested that the Board consider changing the requirements of IFRS 9 in this area.

At its meeting in December 2016, the Board agreed to add a narrow-scope project to its agenda to consider amending IFRS 9 to allow particular financial assets with symmetric make-whole prepayment options to be measured at amortised cost, or FVOCI.

A narrow exception

What's the issue?

The staff described the following symmetric prepayment options set in the original submission it had received:

Make-whole prepayment option	Allows the borrower to prepay the instrument at an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate.
Fair value prepayment option	Allows the borrower to prepay the instrument at its current fair value.

KPMG insight

The original submission described the fair value of a debt instrument – and therefore the exercise price of a fair value prepayment option – as being equal to the remaining contractual cash flows discounted at an interest rate that reflects a current benchmark interest rate, a current credit spread for the borrower and, potentially, a liquidity premium or profit margin.

It also described an example of a make-whole prepayment option exercise price as being based on a current market interest rate reflecting changes in the benchmark rate of interest since the loan was entered into but without providing a comprehensive definition.

How the two types of option are similar or different may depend on how the term ‘current market interest rate’ is understood. For example, in January 2016¹, the committee described the term ‘market rate of interest’ as being linked to the concept of fair value in IFRS 13 *Fair Value Measurement* and including current market spreads. Under such a view, a fair value prepayment option might seem like a type of ‘make-whole’ prepayment option although the staff’s analysis appeared to view the two types of option as mutually exclusive.

The staff’s analysis stated that, in both cases, the prepayment amount may be more or less than the unpaid amounts of principal and interest. If the borrower chooses to prepay the instrument, either the borrower or the lender could in substance receive compensation for early termination – i.e. the compensation could be symmetric.

KPMG insight

The view that the prepayment amount in these cases may be different from unpaid amounts of principal and interest on the principal amount outstanding implies that the term ‘unpaid amounts of principal and interest’ cannot be interpreted as meaning the contractual amounts of principal and interest that the contract would require to be paid in the future (absent prepayment) discounted at a current market rate. However, this is not made explicit in the analysis which may instead rely on understanding the term to approximate to the current outstanding principal plus accrued unpaid interest or maybe to the future contractual cash flows discounted at the asset’s effective interest rate.

Under IFRS 9, a prepayment option results in contractual cash flows that meet the SPPI criterion if the prepayment amount substantially represents unpaid amounts of principal and interest, which may include reasonable additional compensation for early termination of the contract.

The IASB staff believe that this means that the party choosing to exercise its option to terminate the contract should compensate or pay a prepayment penalty to the other party. However, the prepayment options in the table above could result in the lender being forced to accept an amount less than the unpaid amounts of principal and interest. In substance, this represents a payment to the borrower, even though the borrower chose to prepay the debt instrument.

1. [IFRIC Update – January 2016: IAS 39 Financial Instruments: Recognition and Measurement – Separation of an embedded floor from a floating rate host contract in a negative interest rate environment.](#)

A broad range of symmetric prepayments options exists in practice.

The staff's analysis concludes that IFRS 9 would require these instruments to be measured at fair value through profit or loss (FVTPL). However, it may be inappropriate to measure all financial assets with symmetric 'make-whole' prepayment options at FVTPL if they still represent basic lending arrangements.

For this reason, the Board agreed to explore a narrow-scope project to consider whether IFRS 9 should be amended to allow particular financial assets with symmetric make-whole² prepayment options to be measured at amortised cost.

What was discussed?

The staff provided feedback from their additional outreach. The feedback indicated that a broad range of symmetric prepayments options exists in practice:

- In some jurisdictions, prepayment options originate from relevant legal or regulatory requirements in relation to fair competition: others originate from common market practices that exist for commercial purposes.
- Prepayment options occur in many different types of debt instruments, including corporate loans and consumer mortgages.
- Some prepayment options are contingent on the occurrence of specific 'trigger' events while others are freely exercisable.
- Prepayment options may be held by one party or by both parties.
- The prepayment amount or compensation formula varies from contract to contract. For example, there may be a payment to reflect the lender's gain or loss on breaking an associated hedge.

The staff noted that early termination of the contract is permitted in some but required in other cases and that both mandatory and optional prepayments would be considered in developing a possible narrow exception to the SPPI criterion.

The staff also believe that any proposal to allow measurement at amortised cost, or at FVOCI, should be limited to financial instruments for which the effective interest method provides useful and relevant information to users of financial statements.

Asymmetric vs symmetric

IFRS 9 addresses contractual terms that permit either the borrower or the lender to terminate the contract early. If the borrower chooses to terminate the contract early, the prepayment amount may be more than unpaid amounts of principal and interest to compensate the lender. Alternatively, if the lender chooses to terminate the contract early, then the prepayment amount may be less than unpaid amounts of principal and interest to compensate the borrower. These are *asymmetric* prepayment options because the payment of additional amounts depends on which party chooses to exercise its option to terminate the contract early.

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.

In the case of *symmetric* prepayment options, the repayment amount may also be more or less than unpaid amounts of principal and interest. However, the difference

2. For the remainder of this newsletter, we refer to symmetric make-whole prepayment options as symmetric prepayment options.

is that symmetric prepayment options could result in the party that triggers the early termination of the contract effectively receiving a payment from the other party, instead of paying compensation to the other party. The former is referred to as 'negative compensation' and the staff stated that it is not consistent with a basic lending arrangement. This is because 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 than it owes.

The staff believe that the effective interest method could work in the same way for these instruments as long as the symmetric prepayment option does not introduce any different or additional contractual cash flow *amounts* compared with instruments with asymmetric prepayment options. For example, if the prepayment amount reflects only unpaid amounts of principal and interest plus (or minus) the effect of changes in market interest rates, a symmetric option – compared to an asymmetric option – changes only the frequency with which compensation is paid and the direction in which it is paid.

A narrow exception

The staff recommended a narrow exception for particular financial assets with symmetric prepayment options. It also suggested that the scope of that proposed exception be restricted to those symmetric prepayment options that would have met the existing prepayment requirements in IFRS 9 except for the fact that they could incur "reasonable negative compensation for the early termination of the contract".

The staff said that the focus of the Board in accommodating prepayment amounts was to allow compensation for any interest rate differential – i.e. differences in the market interest rate between the prepaid instrument and a new replacement instrument. This interest rate differential approximates the present value of any lost interest income for the lender or any extra interest expense for the borrower due to the early termination. The staff said that the proposed exception would not accommodate any other prepayment amounts which do not meet the requirements in IFRS 9 – e.g. those:

- at fair value because that reflects many factors unrelated to the simple notion of compensating for interest rate changes due to the early termination of the contract; and
- that include the fair value 'cost' to terminate a hedging instrument.

KPMG insight

The staff's comments on this point appear to interpret whether compensation is "reasonable" as opposed to merely whether it is "additional" and suggest that they believe even asymmetric – as opposed to just symmetric – prepayment options of the types described would fail the SPPI criterion. As noted above, this would appear to reflect a narrow concept of 'market interest rate.' Prepayment features of the type described may be common in practice and the staff's view may be different from what many constituents would have expected.

The proposed amendment would have the same effective date as IFRS 9.

Additional eligibility condition

To ensure that the scope of the proposed exception is sufficiently narrow, the staff proposed an additional eligibility condition. For a financial asset with a symmetric prepayment option to be measured at amortised cost or FVOCI, the fair value of the prepayment feature should be insignificant on initial recognition of the asset.

The staff argued that this additional eligibility condition would ensure that it is unlikely that non-SPPI cash flows will occur. The condition is also consistent with the existing exception in IFRS 9 for another narrow group of prepayable assets – i.e. those acquired at a discount or premium and prepayable at the contractual par amount.

KPMG insight

The staff's rationale that the additional eligibility condition would ensure that it is unlikely that non-SPPI cash flows will occur seems to mean that they believe that, if the condition is met, it would be unlikely that the prepayment feature would be exercised such that negative compensation would arise. However, even if exercise is not unlikely, the fair value of the prepayment feature at initial recognition may still be insignificant if the net probability-weighted expected value of differences between prepayment amounts and the fair value of the instrument at exercise is insignificant.

Effective date and transition

The staff recommended that the proposed amendments have the same effective date as IFRS 9 – i.e. annual periods beginning on or after 1 January 2018. This means that entities would not need to apply the SPPI criterion without the exception initially and then change the classification and measurement of some financial assets when the exception becomes effective at a later date.

Consistent with the existing transition requirements for the SPPI criterion, the staff recommended:

- that the proposed exception be applied retrospectively;
- an additional transition provision, which would allow the entity to assess the SPPI criterion on the basis of the facts and circumstances that existed at initial recognition *without taking into account* the proposed exception³; and
- disclosing the carrying amount of those financial assets for which the SPPI criterion is assessed without taking into account the proposed exception until they are derecognised.

The staff prepared a high-level project timeline to facilitate the issue of a final amendment as quickly as possible. They aim to publish an 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.

3. This would apply if it is impracticable for the entity to assess whether the fair value of a prepayment feature was insignificant on the basis of the facts and circumstances that existed at initial recognition of the financial asset

Board member views

The majority of Board members agreed with the staff's recommendation to propose a narrow exception to IFRS 9 for financial assets that do not meet the prepayment requirements only as a result of the symmetric nature of the prepayment features. Some Board members stressed that the exception would only apply for assessing classification and that amortised cost measurement requires ongoing estimation of expected contractual prepayments. One Board member said that the exception would typically apply to assets with long-term interest rate exposure and a key factor would be to determine if the prepayment amount includes reasonable compensation – i.e. does not compensate for fair value exposure. Another Board member argued that break costs to terminate a hedge may be a form of compensation based on the bank's business model but relate to an attribute that is not relevant to amortised cost measurement of these instruments. The majority of Board members also agreed with including the additional eligibility condition.

The Board was in favour of applying the same effective date as IFRS 9 to the proposed exception but agreed that the forthcoming ED include a question about whether a later effective date, with early application permitted, would be more appropriate.

The Board agreed with the proposed transitional provisions. However, one board member noted that where it is impracticable to assess the significance of the prepayment feature, such a feature should still be considered in the measurement even though the proposed exception is not taken into account in the classification assessment.

KPMG insight

A narrow-scope exception may be welcomed by some preparers, especially banks. It would also address cases where the lender obtains a right to early termination when the borrower breaches the contract. In such cases, it may be reasonable for the lender to receive compensation even though they have chosen to exercise their right to terminate.

However, preparers might also be concerned about the effects of changes in the interpretation or application of the standard on their implementation projects. In particular, there may be a significant impact for preparers following staff and Board members' comments about whether the concept of 'reasonable' compensation may include break costs and fair value changes.

This also highlights the challenges for the Board in keeping the scope of the project as narrow as intended as constituents may raise other issues or the deliberations may impact related guidance in IFRS 9.

Doing so will be critical to delivering any final amendment to IFRS 9 by the beginning of the fourth quarter of 2017 ahead of IFRS 9's effective date of 1 January 2018. Even if a final amendment is published in 2017, it may not be available before 2018 for application by companies in jurisdictions where endorsement of new IFRSs into local law is required – e.g. the EU.

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