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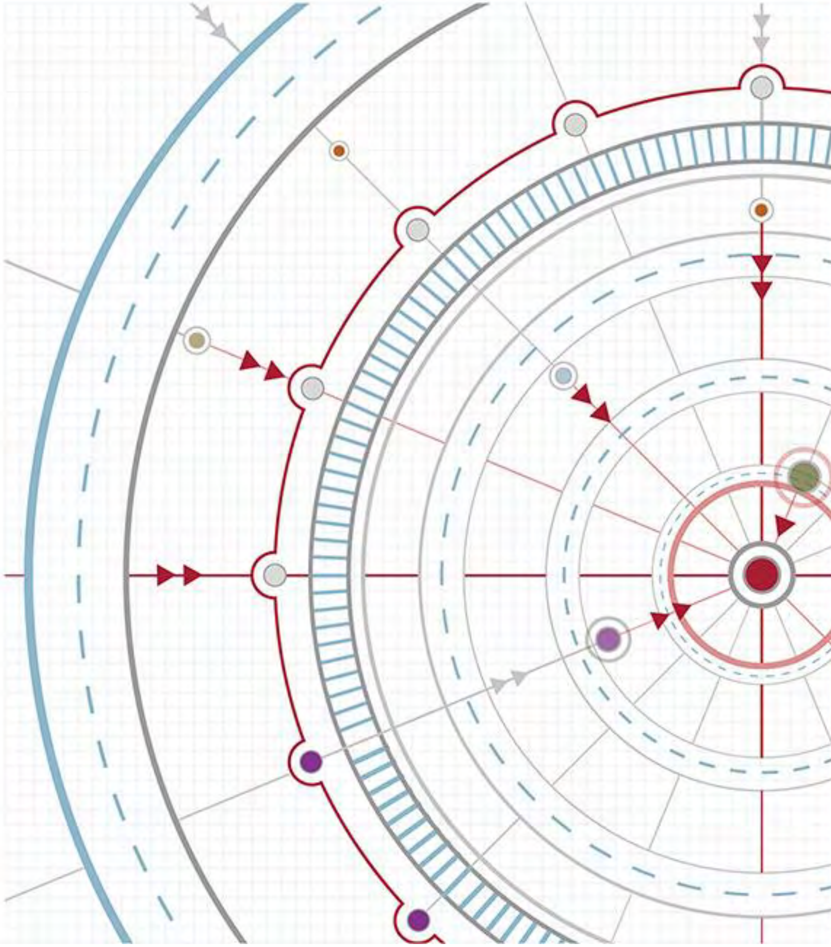

IFRS 9 Symmetric Prepayment Options

Accounting Standards Advisory Forum meeting
March 2017

ASAF agenda paper 7

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Objective and Question

- Objective
  - This presentation provides ASAF members with an overview of the Board's tentative decision to propose a narrow-scope amendment to IFRS 9 *Financial Instruments* on financial assets with symmetric prepayment options.
  - The Board intends to issue the amendment in October 2017. In view of this timetable we would like to use this ASAF session to answer questions that will help support your outreach.
- Question
  - Do ASAF members have any comments on the IASB tentative decisions set out on slide 11 and 12?

Background

- In November 2016, the Interpretations Committee discussed a submission relating to the classification of financial assets that include symmetric prepayment options, applying IFRS 9.
- Most Interpretations Committee members were of the view that the prepayment options described in the submission do not meet the solely prepayments of principal and interest (SPPI) condition and suggested that the IASB consider changing the requirements in IFRS 9.
- In December 2016, the IASB decided to add a narrow-scope project on financial assets with symmetric prepayment options to its agenda, and asked the staff to explore the matter further.
- At the IASB meeting in January 2017, the board decided to propose a narrow-scope amendment to IFRS 9.

Summary of the issue

- The financial assets described in the submission permitted the borrower to prepay the instrument at an amount that could be more or less than unpaid amounts of principal and interest on the principal amount outstanding.
- In other words, it could results in the lender being forced to accept an amount that is less than unpaid amounts of principal and interest ie compensate the borrower even though the option was exercised by the borrower .
- Applying IFRS 9, such contractual cash flows are not solely payments of principal and interest because paragraph B4.1.11(b) only accommodates a situation in which the party who initiates the early termination compensates the other party.

Feedback received

- In some jurisdictions, symmetric prepayment options originate from relevant legal or regulatory requirements and are incorporated in the contractual terms of the contract. In other cases, such options are common market practice that exist for commercial purposes.
- The prepayment options exist in many different types of debt instruments, including corporate loans and consumer mortgages.
- Some are contingent on the occurrence of specific trigger events whilst others are free choices.
- The prepayment option may be held only by one party or by both.
- The prepayment is permitted in some contracts (ie option) whilst it is required in others.

The amortised cost measurement

- Amortised cost provides relevant and useful information about particular financial assets in particular circumstances.
- The objective of the requirements in IFRS 9 to assess an asset's contractual cash flows is to identify instruments for which the effective interest method results in relevant and useful information in predicting the amount, timing and uncertainty about future cash flows of the instruments.
- Therefore, any proposal to measure particular financial assets with symmetric prepayment options at amortised cost must be limited to financial instruments for which the effective interest method provides useful and relevant information to the users of financial statements.

The prepayment amount

- When developing the proposal, the IASB considered the prepayment amounts that could arise from the financial instruments that would be consistent with paragraph B4.1.11(b).
- The IASB noted that the existing notion of ‘reasonable additional compensation for the early termination of the contract’ in B4.1.11(b) of IFRS 9 already accommodates a prepayment amount that is **more or less** than unpaid amounts of principal and interest.
- The IASB noted that the only additional aspect introduced by the symmetric nature of the option was that the prepayment amounts, although consistent with the requirements in B4.1.11(b), could represent ‘negative compensation’.

The prepayment amount—example

- Asset with one-way compensation (B4.1.11(b))

		Prepayment amount
Borrower prepays	Interest rate has increased	Unpaid P&I
	Interest rate has decreased	Unpaid P&I *plus* the effect of change in interest rate
Lender demands prepayment	Interest rate has increased	Unpaid P&I *minus* the effect of change in interest rate
	Interest rate has decreased	Unpaid P&I

- Asset with symmetric prepayment option

Borrower prepays	Interest rate has increased	Unpaid P&I *minus* the effect of change in interest rate
	Interest rate has decreased	Unpaid P&I *plus* the effect of change in interest rate
Lender demands prepayment	Interest rate has increased	Unpaid P&I *minus* the effect of change in interest rate
	Interest rate has decreased	Unpaid P&I *plus* the effect of change in interest rate

The mechanics of amortised cost measurement

- The mechanics of amortised cost measurement would work if the symmetric prepayment option did not introduce any contractual cash flow amounts that are different from the cash flows that are already accommodated by the existing requirements in paragraph B4.1.11(b).
- However, ‘negative compensation’ is not consistent with the notion of a basic lending arrangement, which underpins the SPPI condition in IFRS 9.
- The IASB decided to propose an exception only for this particular feature.

Additional eligibility condition

- As an additional condition, the IASB proposes that a financial asset with symmetric prepayment option is eligible for measurement at amortised cost (or FVOCI) only if the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset.
- The IASB thinks this would be a straight-forward way to limit the scope of the exception and to ensure that financial assets are not measured at amortised cost if it is likely that non-SPPI cash flows will occur.
- Moreover, requiring this additional eligibility condition is consistent with the existing exception in IFRS 9 for another narrow group of prepayable assets in paragraph B4.1.12.

Summary of the IASB decisions

- 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 fair value through other comprehensive income (subject to the financial asset meeting the business model condition) if:
  i. the financial asset would otherwise be consistent with paragraph B4.1.11(b) of IFRS 9 but does not do so only as a result of the symmetric nature of the prepayment feature; and
  ii. when the entity initially recognises the financial asset, the fair value of the symmetric prepayment feature is insignificant.

Summary of the IASB decisions — Effective date and transition

- With respect to the effective date and transition, the IASB tentatively decided:
  - To propose the effective date for the narrow-scope amendment for annual periods beginning on or after 1 January 2018 (the same as that of IFRS 9) and also to include a question in the Exposure Draft about whether a later effective date, with early application permitted, would be more appropriate.
  - To require retrospective application of the proposed amendment subject to transition provision similar to the existing ones.

Project timeline

- The target timeline is as follows:

Timeline	Project plan
April 2017	Publish an Exposure Draft by the end of the month
May 2017	Comment period ends
June-July 2017	Board re-deliberations
October 2017	Issue final amendment by the end of the month

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