

International Financial Reporting Standard

Prepayment Features with Negative Compensation

October 2017

BASIS FOR CONCLUSIONS – AMENDMENTS

[IFRS 9]

[Related to AASB 2017-6]

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Amendments to the Basis for Conclusions on IFRS 9 *Financial Instruments*

This Basis for Conclusions accompanies, but is not part of, IFRS 9.

A footnote is added at the end of paragraphs BC4.51 and BC5.233.

- * In 2017 the IASB discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition of the financial liability. See paragraphs BC4.252–BC4.253.

After paragraph BC4.215, new headings and paragraphs BC4.216–BC4.253 are added.

Classification (Chapter 4)

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Amendments for prepayment features with negative compensation (October 2017)¹

- BC4.216 In 2016, the IFRS Interpretations Committee (Interpretations Committee) received a submission asking how particular prepayable financial assets would be classified 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 (ie the issuer) 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 an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate.
- BC4.217 As a result of such a contractual prepayment feature, the lender (ie the holder) 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 from the lender, instead of compensation *from* the borrower to the lender, even though the borrower chose to prepay the debt instrument. An outcome in which the party choosing to terminate the contract receives an amount, instead of pays an

¹ In this section, the discussion about amortised cost measurement is relevant to both financial assets in the amortised cost measurement category and financial assets in the fair value through other comprehensive income measurement category. That is because, for the latter, the assets are measured at fair value in the statement of financial position and amortised cost information is provided in profit or loss. A financial asset is measured at amortised cost or fair value through other comprehensive income only if both conditions in paragraph 4.1.2 or paragraph 4.1.2A of IFRS 9, respectively, are met. The amendments discussed in this section address only the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Accordingly, this section does not discuss the conditions in paragraphs 4.1.2(a) and 4.1.2A(a) relating to the business model but instead assumes that the asset is held in the relevant business model.

amount, is inconsistent with paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, it is inconsistent with the notion of reasonable additional compensation for the early termination of the contract. In this section of the Basis for Conclusions, such an outcome is referred to as negative compensation. Thus, the financial assets described in the submission would not have contractual cash flows that are solely payments of principal and interest, and those instruments would be measured at fair value through profit or loss applying IFRS 9 (as issued in 2014).

- BC4.218 Nevertheless, Interpretations Committee members suggested that the IASB consider whether amortised cost measurement could provide useful information about particular financial assets with prepayment features that may result in negative compensation, and if so, whether the requirements in IFRS 9 should be changed in this respect.
- BC4.219 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 proposed amendments 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 that may result in negative compensation. The Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) (2017 Negative Compensation Exposure Draft) proposed that such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are held, if two eligibility conditions are met.
- BC4.220 Most respondents to the 2017 Negative Compensation Exposure Draft agreed with the IASB's decision to address the classification of such prepayable financial assets, and highlighted the urgency of the issue given the proximity to the effective date of IFRS 9.
- BC4.221 In October 2017, the IASB amended IFRS 9 by issuing *Prepayment Features with Negative Compensation* (Amendments to IFRS 9), which confirmed with modifications the proposals in the 2017 Negative Compensation Exposure Draft. Specifically, in the amendments issued in October 2017, the IASB amended paragraphs B4.1.11(b) and B4.1.12(b), and added paragraph B4.1.12A of IFRS 9. As a result of those amendments, particular financial assets with prepayment features that may result in reasonable negative compensation for the early termination of the contract are eligible to be measured at amortised cost or at fair value through other comprehensive income.

The prepayment amount

- BC4.222 In developing the 2017 Negative Compensation Exposure Draft, the IASB noted that any proposal to measure at amortised cost financial assets with prepayment features that may result in negative compensation must be limited to those assets for which the effective interest method provides useful information to users of financial statements about the amount, timing and uncertainty of future cash flows. Accordingly, the first eligibility condition proposed in the Exposure Draft was intended to identify those prepayment features that do not

introduce any contractual cash flow amounts that are different from the cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014).

- BC4.223 In the deliberations that led to that proposal, the IASB noted that paragraph B4.1.11(b) of IFRS 9 accommodates contractual terms that permit either the borrower or the lender to choose to terminate the contract early and compensate the other party for having to accept that choice. Accordingly, that paragraph already accommodates a prepayment amount that is more or less than unpaid amounts of principal and interest, depending on which party chooses to terminate the contract early. In applying the effective interest method to measure such financial assets at amortised cost, an entity considers the contractual cash flows arising from such a prepayment feature when it estimates the future cash flows and determines the effective interest rate at initial recognition. Subsequently, consistent with the treatment of all financial instruments measured at amortised cost, the entity applies paragraph B5.4.6 of IFRS 9 and adjusts the gross carrying amount of the financial asset if it revises its estimates of contractual cash flows, including any revisions related to the exercise of the prepayment feature.
- BC4.224 Similarly, for a financial asset with a prepayment feature that may result in negative compensation, the prepayment amount may be more or less than unpaid amounts of principal and interest. However, the difference is that such a prepayment feature may have the result that the party that triggers the early termination of the contract may, in effect, receive an amount *from* the other party, rather than pay compensation *to* the other party. To illustrate this difference, the IASB considered a loan with a prepayment feature that may result in negative compensation. Specifically, both the borrower and the lender have the option to terminate the loan before maturity and, if the loan is terminated early, the prepayment amount includes compensation that reflects the change in the relevant benchmark interest rate. That is, if the loan is terminated early (by either party) and the relevant benchmark interest rate has fallen since the loan was initially recognised, then the lender will effectively receive an amount representing the present value of that lost interest revenue over the loan's remaining term. Conversely, if the contract is terminated early (by either party) and the relevant benchmark interest rate has risen, then the borrower will effectively receive an amount that represents the effect of that change in that interest rate over the loan's remaining term.
- BC4.225 The IASB acknowledged that the contractual terms of the loan described in paragraph BC4.224 do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). That is, the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, the loan's prepayment amount reflects unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. The contractual terms of the loan described in paragraph BC4.224 change only the circumstances in which the compensation

amounts may arise; ie the loan may result in either reasonable additional compensation or reasonable negative compensation for the early termination of the contract.

- BC4.226 The IASB noted that from a computation standpoint, the effective interest method, and thus amortised cost measurement, could be applied to the contractual cash flows that arise from a prepayable financial asset like the loan described in paragraph BC4.224. As described in paragraph BC4.223, the entity would consider the prepayment feature when it estimates the future cash flows and determines the effective interest rate. Subsequently, the entity would apply paragraph B5.4.6 of IFRS 9 and make a catch-up adjustment if it revises its estimates of contractual cash flows, including any revisions related to the prepayment feature.
- BC4.227 Furthermore, the IASB decided that amortised cost measurement could provide useful information to users of financial statements about financial assets whose prepayment amount is consistent with paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) in all respects except that the party that chooses to terminate the contract early may receive reasonable compensation for doing so. That is because, as discussed in paragraph BC4.225, such prepayment features do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014); ie the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Therefore, the 2017 Negative Compensation Exposure Draft proposed an eligibility condition that was intended to capture those prepayment features that would have been accommodated by paragraph B4.1.11(b) except that a party may receive reasonable compensation for the early termination of the contract even if it is the party that chooses to terminate the contract early (or otherwise causes the early termination to occur).
- BC4.228 Nearly all respondents agreed with that eligibility condition proposed in the 2017 Negative Compensation Exposure Draft. Specifically, they agreed that reasonable negative compensation for the early termination of the contract should not in itself preclude amortised cost measurement. The respondents agreed with the IASB's rationale described in paragraphs BC4.226–BC4.227 and they also agreed that the proposed eligibility condition would capture a population of financial assets for which amortised cost measurement could provide useful information to users of financial statements. The respondents said that measuring such assets at amortised cost, and including them in key metrics like net interest margin, would provide useful information to users of financial statements about the financial assets' performance. Those respondents consider information about expected credit losses and interest revenue (calculated using the effective interest method) to be more relevant than information about changes in fair value for the purpose of assessing the performance and future cash flows of those financial assets.
- BC4.229 Consequently, in its redeliberations of the 2017 Negative Compensation Exposure Draft, the IASB confirmed that proposed eligibility condition. As a result, applying the amendments, a financial asset with a prepayment feature that may result in negative compensation is eligible to be measured at amortised

cost or fair value through other comprehensive income if it would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable *negative* compensation for the early termination of the contract.

- BC4.230 However, one respondent said that the IASB had not addressed the case in which the early termination of the contract is caused by an event that is outside the control of both parties to the contract, such as a change in law or regulation. That respondent asked the IASB to clarify the amendments in that regard. The IASB agreed with that observation. Consequently, the wording in paragraph B4.1.12A of the amendments refers to the *event or circumstance* that caused the early termination of the contract. Such an event or circumstance may be within the control of one of the parties to the contract (for example, the borrower may choose to prepay) or it may be beyond the control of both parties (for example, a change in law may cause the contract to automatically terminate early).

Other prepayment amounts

- BC4.231 As described in paragraph BC4.229, the IASB decided to limit the scope of the amendments to those financial assets with prepayment features that would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable negative compensation for the early termination of the contract. The IASB observed that the effective interest method, and thus amortised cost measurement, are not appropriate when the prepayment amount is inconsistent with that paragraph for any other reason.
- BC4.232 As described in the submission to the Interpretations Committee, some financial assets are prepayable at their current fair value. The IASB is also aware that some financial assets are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument (which may or may not be in a hedging relationship with the prepayable financial asset for accounting purposes). Some interested parties suggested that both of those types of prepayable financial asset should be eligible for amortised cost measurement. The IASB acknowledged that there may be some circumstances in which such a contractual prepayment feature results in contractual cash flows that are solely payments of principal and interest in accordance with IFRS 9, as amended; ie there may be circumstances in which the compensation included in such a prepayment amount is reasonable for the early termination of the contract. For example, that may be the case when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. However, the Board observed that it will not always be the case and therefore an entity cannot presume that all such prepayable financial assets are eligible to be measured at amortised cost. Entities must assess an instrument's specific contractual cash flow characteristics.

The probability of prepayment

- BC4.233 A prepayment feature that may result in negative compensation changes the circumstances, and increases the frequency, in which the contractual compensation amounts could arise. Accordingly, in the deliberations that led to

the publication of the 2017 Negative Compensation Exposure Draft, the IASB observed that if such a prepayable financial asset is measured at amortised cost, the likelihood is higher that the lender will be required to make catch-up adjustments applying paragraph B5.4.6 of IFRS 9 to reflect revisions to its estimates of contractual cash flows related to the exercise of the prepayment feature. This could include adjustments to reflect circumstances in which the lender is forced to settle the contract in a way that it would not recover its investment for reasons other than the asset's credit quality. The IASB observed that recognising frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the objective of the effective interest method, which is a relatively simple measurement technique that allocates interest using the effective interest rate over the relevant time period. Recognising more frequent adjustments in the gross carrying amount could reduce the usefulness of the interest amounts that are calculated using such a simple measurement technique and could suggest that fair value measurement would provide more useful information.

- BC4.234 Consequently, the IASB proposed a second eligibility condition in the 2017 Negative Compensation Exposure Draft. That eligibility condition would have required that the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. The objective of that proposed eligibility condition was to limit further the scope of the amendments so that financial assets would be eligible to be measured at amortised cost only if it is unlikely that prepayment, and thus negative compensation, would occur.
- BC4.235 While some respondents agreed with that proposed eligibility condition, others disagreed and expressed concerns about matters such as how difficult the condition would be to apply, whether it would unduly restrict the scope of the amendments and whether it would achieve the IASB's stated objective. Most of the respondents that disagreed with the second eligibility condition said the first eligibility condition (discussed above in paragraphs BC4.222–BC4.232) was sufficient. They expressed the view that the requirements in paragraph B4.1.11(b) of IFRS 9 should accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie an entity should be required to assess negative compensation for the early termination of the contract in the same way as it assesses additional compensation for the early termination of the contract. Some respondents suggested alternatives that they thought would better achieve the IASB's objective. Those suggestions included assessing the probability that prepayment, or negative compensation, will occur.
- BC4.236 During its redeliberations, the IASB observed that the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would, in some cases, achieve its objective. That is because the fair value of the prepayment feature would take into account the likelihood that prepayment will occur. Accordingly, if it is very unlikely that prepayment will occur, then the fair value of the prepayment feature will be insignificant. The IASB also reconfirmed its view that the scope of the amendments must be limited to financial assets for which the effective interest method, and thus amortised cost, can provide useful information, and observed that a second eligibility condition would be helpful to precisely identify the relevant population.

- BC4.237 However, the IASB acknowledged the concerns expressed by respondents. The Board agreed with the concern that the fair value of a prepayment feature would reflect not only the probability that reasonable negative compensation will occur, but it would also reflect the probability that reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)) will occur. In some circumstances, the fair value of the prepayment feature may be more than insignificant due largely, or entirely, to the latter. In such circumstances, the financial asset would not meet the second eligibility condition even if the holder determined that it was very unlikely that negative compensation will occur.
- BC4.238 The IASB also noted concerns that the fair value of the prepayment feature could be insignificant even if it is likely that negative compensation may occur. For example, that could be the case if the compensation structure of the prepayment feature is symmetrical so that the effect of reasonable negative compensation on that feature's fair value is offset by the effect of reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)), or if the prepayment amount is close to the instrument's fair value at the prepayment date.
- BC4.239 Consequently, during its redeliberations, the IASB concluded that, in some circumstances, the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would not restrict the scope of the amendments in the way that the IASB intended and, in other circumstances, could restrict the scope in a way that the IASB did not intend. Therefore, on balance, the IASB decided not to confirm the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft.
- BC4.240 The IASB noted that the alternatives to the second eligibility condition that were suggested by respondents were not discussed in the 2017 Negative Compensation Exposure Draft and therefore interested parties did not have the opportunity to provide feedback on them. Many respondents to that Exposure Draft highlighted the importance of finalising the amendments before the effective date of IFRS 9 and the IASB noted that prioritising such timing would preclude the Board from conducting outreach to assess those alternatives. Moreover, the IASB doubted whether those alternatives would better achieve its objective without introducing significant complexity to the amendments. Therefore, the IASB decided not to replace the second proposed eligibility condition with any of those alternatives.

Corresponding amendment to paragraph B4.1.12

- BC4.241 As a consequence of its decisions to confirm the first proposed eligibility condition and remove the second proposed eligibility condition, the IASB observed that paragraph B4.1.11(b) of IFRS 9 will accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie entities will be required to assess all amounts of reasonable compensation for the early termination of the contract in the same way.
- BC4.242 Accordingly, the IASB amended paragraph B4.1.12(b) of IFRS 9 to align it with paragraph B4.1.11(b). As a result, paragraph B4.1.12(b) also accommodates

reasonable negative compensation for the early termination of the contract. The IASB decided that there was no compelling reason to treat the notion of reasonable compensation for the early termination of the contract in paragraph B4.1.12(b) of IFRS 9 differently from that notion in paragraph B4.1.11(b).

Effective date

- BC4.243 The 2017 Negative Compensation Exposure Draft proposed that the effective date of the amendments would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018, with earlier application permitted.
- BC4.244 Some respondents agreed with that proposal and said there would be significant benefits if entities take into account the effect of the amendments when they initially apply IFRS 9. In contrast, others preferred a later effective date for the amendments; specifically, annual periods beginning on or after 1 January 2019 (with earlier application permitted). These respondents observed that many entities are advanced in their implementation of IFRS 9 and may not have sufficient time before the effective date of IFRS 9 to determine the effect of these amendments. Additionally, some jurisdictions will need time for translation and endorsement activities and the proposed effective date may not provide them with sufficient time for those activities.
- BC4.245 In the light of the feedback received, the IASB decided to require that entities apply the amendments for annual periods beginning on or after 1 January 2019, with earlier application permitted. This alleviates the concerns about the timing of these amendments while also permitting an entity to apply the amendments and IFRS 9 at the same time if it is in a position to do so.

Transition

Entities that initially apply the amendments and IFRS 9 at the same time

- BC4.246 As described in paragraph BC4.245, an entity is permitted to apply the amendments earlier than the mandatory effective date and, as a result, can take into account the effect of the amendments when it initially applies IFRS 9. In such cases, an entity would apply the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) to all financial assets and financial liabilities within the scope of that Standard. No specific transition provisions are needed for the amendments.

Entities that initially apply the amendments after previously applying IFRS 9

- BC4.247 Some entities will apply the amendments after they have already applied IFRS 9. The IASB considered whether specific transition requirements are needed for those entities because, without such additional transition requirements, the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) would not be applicable. That is because, as set out in paragraph 7.2.27 of IFRS 9, an entity applies each of the transition provisions in IFRS 9 only once; ie at the relevant date of initial application of IFRS 9. This means that entities would be required

to apply the amendments retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, in some circumstances, an entity may not be able to apply the amendments retrospectively without the use of hindsight. When the IASB developed the transition requirements in IFRS 9, it provided requirements to address scenarios when it would be impracticable to apply particular requirements retrospectively. Accordingly, the IASB decided to provide transition requirements for entities that apply the amendments after they have already applied IFRS 9.

- BC4.248 Consistent with the existing transition requirements in IFRS 9 for assessing whether the contractual terms of a financial asset give rise to cash flows that are solely payments of principal and interest, the amendments must be applied retrospectively. To do so, an entity applies the relevant transition provisions in IFRS 9 necessary for applying the amendments. For example, an entity applies the transition requirements in paragraph 7.2.11 related to the effective interest method and paragraphs 7.2.17–7.2.20 related to the impairment requirements to a financial asset that is newly measured at amortised cost or fair value through other comprehensive income as a result of applying the amendments.
- BC4.249 The IASB provided specific transition provisions related to the fair value option because an entity may change the classification and measurement of some financial assets as a result of applying the amendments. Therefore, an 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 exists, as a result of applying the amendments.
- BC4.250 Finally, the IASB decided that an entity is not required to restate prior periods to reflect the effect of the amendments, and could choose to do so only if such restatement is possible without the use of hindsight and if the restated financial statements reflect all the requirements in IFRS 9. This decision is consistent with the transition requirements in IFRS 9.
- BC4.251 In addition to any disclosures required by other IFRS Standards, the IASB required disclosures that would provide information to users of financial statements about changes in the classification and measurement of financial instruments as a result of applying the amendments. These disclosures are similar to the disclosures in paragraphs 42I–42J of IFRS 7, which are required when an entity initially applies IFRS 9.

Another issue

Modification or exchange of a financial liability that does not result in derecognition

- BC4.252 Concurrent with the development of the amendments to IFRS 9 for prepayment features with negative compensation, the IASB also discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. More specifically, at the request of the Interpretations Committee, the Board discussed whether, applying IFRS 9, an entity recognises any adjustment to the amortised

cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification or exchange.

- BC4.253 The IASB decided that standard-setting is not required because the requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. In doing so, the Board highlighted that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in the derecognition of the financial liability are consistent with the requirements for adjusting the gross carrying amount of a financial asset when a modification does not result in the derecognition of the financial asset.