Australian Government
Australian Accounting Standards Board

Staff Paper

Project:	AASB 9 *Financial Instruments*	**Meeting**	AASB March 2017 (M156)
		Date	14 March 2017
Topic:	Symmetric prepayment options	**Agenda Item:**	6.1
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Introduction and objective of this paper

1 The objective of this paper is to obtain the Board's decision on whether to comment on an expected International Accounting Standards Board (IASB) Exposure Draft (ED). The ED is expected to propose narrow scope amendments to IFRS 9 *Financial Instruments* to allow financial assets with symmetric 'make-whole' prepayment options to be measured at amortised cost. Paragraphs 5–9 of this paper provide further detail on this feature.

2 Relevant extracts of paragraphs in IFRS 9 referred to in this paper are included in Appendix A.

Link to project summary

3 http://www.ifrs.org/Current-Projects/IASB-Projects/Symmetric%20Prepayment%20Options/Pages/default.aspx

Attachments

Agenda paper 6.2 March 2017 ASAF Paper

Agenda paper 6.3 Summary of February 2017 AASB FI PAP Meeting

Summary of staff recommendation

4 Staff recommend the Board not make a submission on the expected IASB ED.

Background

5 IFRS 9 *Financial Instruments* requires financial assets to be classified and subsequently measured at either amortised cost or fair value (either through profit or loss, or other comprehensive income (OCI)). The classification and subsequent

measurement approach is driven by the entity's business model for the financial asset **and** the characteristics of the cash flows arising from that financial asset.

6 To subsequently measure a financial asset at amortised cost the objective must be to hold the asset in order to collect contractual cash flows **and** the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (the SPPI test). This is intended to reflect a basic lending arrangement.

7 Instruments that include prepayment clauses do not necessarily fail the SPPI test. Where such a clause exists, to meet the SPPI test the prepayment amount should substantially represent unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract (IFRS 9.B4.1.11(b)).

8 Typically, prepayment clauses adjust the prepayment amount to compensate the party that has not initiated the early termination of the contract. For example, if the borrower choses to prepay the instrument and terminate the contract early, then the borrower would typically compensate the lender for that action, and vice versa. However, a **symmetric** prepayment option adjusts the prepayment amount to compensate the party that suffers an 'economic loss'[1] because of early termination, which might be the party that initiated the termination.

9 In the event a borrower prepays an instrument and subsequently receives a benefit under the symmetric prepayment clause, the lender would in effect experience 'negative compensation'. This notion of 'negative compensation' is not currently contemplated in AASB 9, which refers only to 'reasonable additional compensation'. Consequently, instruments with symmetric prepayment options fail the SPPI test and are subsequently measured at fair value through profit or loss.

10 A submission to the IFRS Interpretations Committee (IFRS IC) and later IFRS IC deliberations acknowledged that the presence of a symmetric prepayment option should not prevent an instrument from being subsequently measured at amortised cost if that instrument would otherwise meet the SPPI condition and amortised cost would provide the most relevant and useful information for that instrument.

Expected proposals

11 The ED is expected to propose an 'exception' to the SPPI test so that a financial instrument with a symmetric prepayment option is not automatically excluded from subsequent measurement at amortised cost or fair value through OCI.

12 The exception will likely permit instruments that would otherwise be consistent with paragraph B4.1.11(b) but for the symmetric prepayment option, to be measured at amortised cost or fair value through OCI, provided that the symmetric prepayment feature has an insignificant fair value on initial recognition.

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1 The term 'economic loss' is used loosely here to refer to the party that is adversely affected by movements in interest rates. For example, if the borrower prepaid a fixed-rate instrument after market rates had increased, the borrower would receive 'compensation' under a symmetric prepayment clause.

Feedback from outreach

13 The AASB's Financial Instruments Project Advisory Panel (FI PAP)considered the March 2017 ASAF agenda paper on the proposed narrow scope amendments to IFRS 9 in relation to symmetric prepayment options (see Agenda Paper 6.2) at its February 2017 meeting (see Agenda Paper 6.3). Feedback from the FI PAP indicated broad support for the proposed narrow scope amendment i.e. the 'exception' as outlined in paragraphs 12-13 above.

14 However, the panel noted that the fair value of a symmetric prepayment option is likely to be insignificant only on origination of the instrument. If an instrument was acquired (either separately or as part of a business combination) at any time after origination, the fair value of the prepayment option might be significant. Therefore, the 'exception' might not fully address all transactions involving instruments with these options.

15 The panel urged the IASB to address the above issue as a matter of priority in the current project. If all purchased/acquired financial assets with symmetric prepayment options were to be subsequently measured at fair value (when they otherwise would be at amortised cost) simply because they fail the 'insignificant fair value' test', financial statements would become less useful to users.

16 However, if the IASB makes a conscious decision that the exception for symmetric prepayment options would only be for financial assets with 'insignificant fair value' for symmetric prepayment options on initial recognition (even though this most likely exclude similar instruments that are purchased rather than originated), then the IASB should include in its basis of conclusions to the amendments as to why it made that decision.

17 The above feedback was conveyed to the IASB at the March 2017 ASAF meeting.

Timeline

18 The IASB plans to finalise these amendments prior to the mandatory application date of 1 January 2018 for IFRS 9. Accordingly, the forthcoming ED on symmetric prepayment options will have a **30-day** comment period. The timeline below shows the current IASB project plan.

	IASB project plan
April	Publish ED by the end of the month
May	30-day comment period ends
June-July	Board re-deliberations
October	Issue final amendments by the end of the month

19 The AASB is scheduled to meet on 1-3 May and 27-28 June. Therefore, any consideration of a AASB comment letter would need to occur out-of-session, if the Board intends to submit one.

20 As noted in the table above, the IASB is aiming to issue the final amendments by the end of October to allow entities sufficient time to understand the amendments prior to applying IFRS 9. For the same reason, AASB staff intend to issue the Australian equivalent amendments as soon as possible, which might require out-of-session voting prior to the 12-13 December AASB meeting.

Staff recommendation

21 Staff observe the planned amendments would be very narrow in scope and would affect a relatively small population of entities (loan providers with these options included in their contracts). Furthermore, limited consultation has indicated broad support for the IASB's proposed amendments.

22 Accordingly, staff **do not** recommend the Board make a formal submission on the expected IASB ED. .

Question for Board members
Do Board members agree with staff recommendation not to make a submission on the forthcoming IASB ED proposing narrow scope amendments to IFRS 9 to permit amortised cost measurement for financial assets with symmetric prepayment options?

Appendix A

B4.1.7A Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money (see paragraphs B4.1.9A–B4.1.9E) and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risks) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

…

B4.1.10 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are solely payments of principal and interest on the principal amount outstanding. To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (ie the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator …

B4.1.11 The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

(a) …

(b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract; and

(c) …

B4.1.12 Despite paragraph B4.1.10, a financial asset that would otherwise meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay a debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (subject to meeting the condition in paragraph 4.1.2(a) or the condition in paragraph 4.1.2A(a)) if:

(a) the entity acquires or originates the financial asset at a premium or discount to the contractual par amount;

(b) the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for the early termination of the contract; and

(c) when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.