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IFRS 9 Amendment - 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 TEG members' views on these decisions, including:

(a) an update of how common these features currently are within Europe;

(b) issues to be considered when assessing whether symmetric prepayment options can be measured at amortised cost or fair value through other comprehensive income ('FVOCI'), subject to the financial asset meeting the business model condition if certain conditions are met; and

(c) the project timeline and effective date.

2 During the meeting an oral update will be provided of the discussion held at the EFRAG FIWG conference call of 23 March 2017.

Table of Contents

Background

3 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.

4 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.

5 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.

6 As an additional eligibility condition, the IASB proposed that a financial asset with a symmetric prepayment option is eligible for measurement at amortised (or FVOCI) only if the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. This is 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 solely payments of principal and interest (‘SPPI’) cash flows will occur, then this additional eligibility condition ensures that these financial assets are not measured at amortised cost.

Introduction

Scope of the proposal

7 The IASB proposal targets symmetric ‘make whole’ prepayment options only, and excludes fair value prepayment options:

(a) A symmetric ‘make whole’ prepayment option allows the borrower to prepay the debt instrument at an amount that reflects the remaining cash flows of the instrument discounted at a current market interest rate.

(b) A fair value prepayment option allows the borrower to prepay the debt instrument at its current fair value.

8 In both types the prepayment amount may be more or less than unpaid amounts of principal and interest. Also, the IASB proposal targets symmetric prepayment options that are part of the contractual terms of the financial asset.

Comparison with IAS 39

9 A financial asset host that is within the scope of IFRS 9 is not assessed for embedded derivatives, because the SPPI criterion is applied to the entire hybrid contract to determine the appropriate measurement category. However, many embedded derivatives introduce variability to cash flows, which is not consistent with the notion that the instrument’s contractual cash flows represent SPPI. The requirements in paragraph B4.1.11(b) of IFRS 9 are similar in some respects to the

prepayment requirements referenced in the embedded derivative requirements in IAS 39 *Financial Instruments: Recognition and Measurement*.

10 Consistent with paragraph AG30(g) of IAS 39, paragraph B4.3.5(e) of IFRS 9 states that embedded calls, puts and prepayment options are not closely related to the host debt contract, unless:

(a) the option's exercise price is approximately equal, on each exercise date, to the host debt instrument's amortised cost; or

(b) the exercise price of the prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the host contract's remaining term. Lost interest is the product of the outstanding principal amount multiplied by the interest differential. The interest differential is the difference between the effective interest rate on the host contract and the effective interest rate that could be obtained by the lender if it invested the principal at the repayment date for the host contract's remaining term in a similar contract.

11 As explained in the Basis for Conclusions on IAS 39, lost interest represents the penalty that the borrower must pay to the lender when exercising the prepayment option in order to reduce the lender's reinvestment risk. Therefore, like IFRS 9, IAS 39 incorporates a notion of 'compensation'.

12 The requirements in paragraph B4.1.11(b) of IFRS 9 also contemplate a contractual term that permits the lender to put a debt instrument back to the borrower before maturity. Therefore, it does not specify which party (i.e. the borrower or the lender) pays compensation for the early termination of the contract.

13 Symmetric prepayment options could have the result of negative compensation where the lender is forced to accept an amount that, in effect, represents a payment to the borrower, even though the borrower chose to prepay the debt instrument. This is because under a symmetric prepayment option the additional payment amount does not depend on which party chooses to exercise its option to terminate the contract early. Instead, that amount depends only on the movement in market interest rates since the asset was originally recognised.

14 The above would contradict the notion of compensation and could have the effect that the lender would receive a prepayment amount that is substantially less than unpaid amounts of principal and interest. In these circumstances the lender could also be forced to settle the contract in a way that it would not recover its investment. If that is the case, it could also be considered to be inconsistent with the notion of "reasonable additional compensation for the early termination of the contract".

Feedback received from EFRAG FIWG

15 The EFRAG Secretariat received information about symmetric prepayment options that exist in Europe. This information was provided on an informal and confidential basis and therefore the following observations are made on an aggregated basis only.

(a) These symmetric prepayment options exist in various types of loans (corporate loans, mortgages, private loans) in various jurisdictions across Europe. They are most common in the aviation industry in Europe, in the social housing sector in the UK, in local authorities financing in the UK and France, in some mortgage loans in Netherlands, and in some Switzerland private client loans. These are cases of both symmetric make whole prepayment options and fair value prepayment options.

(b) Symmetric prepayment options do not arise from any legal or regulatory requirement, but rather are common market practice for commercial purposes.

(c) The prepayment option may be held by only one party to the contract or by both parties, but in most cases reported to the EFRAG Secretariat, it was held by the borrower.

(d) Prepayment options are generally not contingent on the occurrence of any specific 'trigger' event; in some contracts they can only be exercised at certain dates.

(e) From the feedback received, the prepayment amount is calculated mostly on an individual instrument basis, but the 'compensation formula' could vary. It could be:

  (i) higher of a) the principal amount plus accrued interest and b) the present value of remaining cash flows, discounted at a rate that is linked to a reference bond plus/minus a margin;

  (ii) the undiscounted principal amount plus accrued interest to the prepayment date plus/minus an adjustment being equivalent to a hypothetical/notional interest rate swap determined at inception for the term of the instrument and described clearly in the loan agreement. This hypothetical derivative is in effect trying to capture the present value of the interest differential between i) the benchmark interest rate curve determined when the loan was originated (and so described as the fixed leg of the swap) and ii) the benchmark interest rate curve for the remaining maturity at the date of prepayment; or

  (iii) the undiscounted principal amount plus accrued interest to the prepayment date plus an adjustment being equivalent to the bank's actual break cost for terminating the swap on the loan. In this case the break clause includes the credit risk of the swap and other liquidity issues as it will be the cost the bank incurs terminating its interest rate swap with its counterparty.

16 Some prepayment clauses are based upon a benchmark rate increased with an additional credit margin which is defined based on the average credit risk of the entire portfolio of loans. In assessing such a situation, one can consider two points of view:

(a) At origination of the loan, the additional credit margin charged was in line with the credit risk of the borrower. However, over time the situation of the borrower has improved (allowing for prepayment) and its credit margin lowered. Charging the original credit margin determined at inception can be seen as a compensation for taking the credit risk at inception; or

(b) At origination of the loan, the additional credit margin was in line with the credit risk of the borrower, as well as all other borrowers in the same portfolio. The fact that the credit risk of one borrower improves, is offset by the deterioration of the credit risk of another borrower in the same portfolio. Hence, charging the original credit margin determined at inception can be seen as mutualisation of gains and losses within the same portfolio of loans.

17 According to the feedback received, the rate used to discount the remaining cash flows can be an average rate of a number of banks for that particular product and there is currently diversity in practice on whether the discount rate can include some additional margins to compensate the lender for reinvestment risk and lost interest.

EFRAG Secretariat analysis

Definition of interest under IFRS 9

18 The EFRAG Secretariat recalls that IFRS 9, paragraph B4.1.7A notes the following: "*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 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 risk) 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 arrangements. In extreme economic circumstances, interest can be negative."

De minimis and non-genuine features

19 The EFRAG Secretariat recalls that IFRS 9, paragraph B4.1.18 notes that '*A contractual cash flow characteristic does not affect the classification of the financial asset if it could have only a de minimis effect on the contractual cash flows of the financial asset*.'

20 Further, IFRS 9, paragraph B4.1.18 notes that '*A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur*.'

21 The EFRAG Secretariat assesses that make whole prepayment options are neither de minimis nor non-genuine features of basic lending instruments.

Distinguishing between make whole prepayment options and fair value prepayment options

22 As noted in paragraph 7 above, the borrower holding a symmetric make whole prepayment option, can prepay the instrument at an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate whilst if they hold a fair value prepayment option it can be prepaid at the instrument's current fair value.

23 A financial asset that is prepayable at fair value does not meet the requirements in paragraph B4.1.11(b) of IFRS 9 because such a prepayment amount reflects factors unrelated to a basic lending instrument such as exposure to equity or commodity risk (and thus fair value measurement is more appropriate for financial instruments with such 'complex' cash flows).

Discount rate to be used

24 A symmetric make whole prepayment option may allow the borrower to prepay a debt instrument at an amount that corresponds to the remaining contractual cash flows of the instrument discounted at a current market rate of interest (for example, reflecting changes in the benchmark rate of interest since the loan was entered into). Consistent with the definition of interest in paragraph B4.1.7A of IFRS 9, the interest rate stipulated in the debt instrument is a function of the following factors: risk-free interest rate, credit risk, time value of money, liquidity risk and a reasonable profit margin.

25 Based on the feedback received, the EFRAG Secretariat noted the discount rate may take many forms such that it can be one of the following:

(a) risk free rate;

(b) current market rate for the remaining maturity at the prepayment date;

(c) a referenced benchmark rate plus a premium as agreed upfront in the agreement; or

(d) an average rate of a number of banks for that particular product.

Nature of additional margins

26 As noted above, the prepayment amount corresponds to the remaining contractual cash flows of the instrument discounted at a current market rate of interest which may reflect changes in the interest rate included in the contract since origination.

27 Based on the feedback received, the EFRAG Secretariat noted that there is diversity in practice on whether the discount rate can include some additional margins to compensate the lender for reinvestment risk and lost interest. Some have indicated that additional margins may take many forms for example:

(a) the present value of the interest differential between benchmark interest rate curve determined when the loan was originated and the benchmark interest rate curve for the remaining maturity at the date of prepayment;

(b) a breakage gain or loss calculated with reference to the fair value of a notional swap which compares the hedged rate and market benchmark rates at the time of prepayment; or

(c) the difference between the remaining principal plus accrued interest and the present value of the remaining cash flows discounted at a rate linked to a referenced bond plus/minus a margin.

28 The EFRAG Secretariat assesses that the inclusion of additional margins would not prevent conformity with the SPPI-criterion to the extent that these additional margins are in line with what interest represents as described in paragraph 18 above.

29 The EFRAG Secretariat doubts whether a reference to 'an average rate of a number of banks for that particular product' would fulfil that condition as those other rates include margins (such as credit risk) that are unrelated to the borrower.

What is 'reasonable' compensation?

30 In order to pass the SPPI criterion the prepayment amount needs to represent 'reasonable additional compensation for the early termination of the contract' as described in paragraph B4.1.11 (b) of IFRS 9. The EFRAG Secretariat notes the current proposal does not alter the reading of these words under IFRS 9, with the sole exception that the sign of the compensation can be negative.

31 Some contracts add a margin to the prepayment amount which is described as 'broken funding costs/gains' and which can be described as the loss/benefit of interest income for the lender compared to placing an amount equal to the prepaid amount on deposit with another bank. The EFRAG Secretariat notes that sight deposits have a duration of one day, while the remaining duration of the prepaid loan may be of several years. The EFRAG Secretariat further notes that funding may be provided by equity and not by deposits.

32 Consequently, the EFRAG Secretariat assesses that distinguishing between a reasonable compensation and a compensation that includes leverage will require judgement.

Reference to market place conventions

33 In some cases, a contract contains a prepayment option but the way it is calculated is not defined in the contract itself, instead the contract refers to market place conventions. The EFRAG Secretariat assesses that in such a case, the resulting cash flows do not only arise from the market place convention but because of the contractual reference, they are part of the contractual agreement.

Unit of account

34 The EFRAG Secretariat is of the view that the unit of account is the financial instrument level and offsetting of gains and losses between different financial instruments is not permitted.

The project timeline

35 The target project timeline as proposed by the IASB 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	IASB re-deliberations
October 2017	Issue final amendment by the end of the month

36 The EFRAG Secretariat recalls the implementation date of IFRS 9 being 1 January 2018. Consequently, the project plan leaves little room for the EU endorsement process to be finalised before 1 January 2018.

37 The EFRAG Secretariat acknowledges the possibility to work with a later implementation date with retrospective application. However, that would oblige entities to measure financial assets containing such prepayments options at fair value, and correct that measurement sometime later. It is unclear if this can be done without undue cost or effort.

EFRAG Secretariat recommendation

38 The EFRAG Secretariat:

(a) supports the proposal of the IASB 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 particular symmetric prepayment features as long as the symmetric prepayment option does 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) of IFRS 9;

(b) agrees with the additional eligibility condition as proposed by the IASB that a financial asset with a 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;

(c) acknowledges that the discount rate may be adjusted for changes in the benchmark interest rate since the loan was entered into. Those changes may also include a premium as agreed upfront as long as those changes are consistent with those expected in a basic lending arrangement and does not introduce or create leverage (i.e. these features do not increase the variability of the contractual cash flows with the result that they do not have any longer the economic characteristics of interest); and

(d) acknowledges that IFRS 9 requires the SPPI criterion to be assessed on an instrument by instrument basis and therefore the cash flows arising from symmetric prepayment options should also be assessed on that level.

39 Regarding the project timeline, the EFRAG Secretariat proposes to add a question to constituents into EFRAG's draft comment letter to find out whether working with later implementation date than 1 January 2018 but with retrospective application can be done without undue cost or effort.

Questions for EFRAG TEG

40 Does EFRAG TEG agree that instruments with symmetric make whole prepayment options be measured at amortised cost or FVOCI? That is, does the EFRAG TEG consider that a positive draft comment letter is appropriate?

41 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? How would you propose to avoid additional costs related to such an approach?

42 Does EFRAG TEG have any other comments at this stage?