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Examples of prepayment features with negative compensation
Issues Paper

Objective

1 The objective of this paper is to provide illustrations of prepayment features with negative compensation, allowing EFRAG TEG members to assess the eligibility criteria for the proposed exception to the solely payments of principal and interest (SPPI) criterion in measuring financial instruments in accordance with IFRS 9 *Financial Instruments*.

Background

2 The examples described in the Appendix to this paper have been made available to the EFRAG Secretariat by a European bank. According to the bank, Example 5 is the clause most commonly used in the existing contracts of the bank. The bank has assessed all of the examples and notes that they would not pass the SPPI-criterion *only* because of the occurrence of a prepayment feature with negative compensation. All of the prepayment features in the different examples have a fair value at inception that is close to zero.

3 Consequently, according to the bank, when adopted, the Amendments to IFRS 9 as proposed by the IASB would allow financial instruments with such prepayment features to be measured at amortised cost or at fair value through other comprehensive income (subject to fulfilling the business model criterion).

4 The Appendix summarises the contractual requirements of five different contracts. The EFRAG Secretariat has reflected the contractual clauses as follows:

(a) On places where the clauses have been shortened, this is indicated by […];

(b) The conditions that could lead to negative compensation have been underlined in each of the examples;

(c) The footnotes reflect additional background to the clauses; and

(d) Text in italic refers to the possibility in the local legal framework that the bank needs to consent before prepayment can be done. That particular clause may or may not be included in the contract (see also footnote 2).

Question for EFRAG TEG

5 Do EFRAG TEG members have any comments on the examples provided?

Appendix 1: Summary of contract clauses

Example 1:

1 The borrower may make early repayment of this loan, wholly or in part, subject to the following limitations, provided that the borrower gives 15 days' advance notice.

2 In that event, the Parties must compensate one another for the total or partial loss caused by the repayment to be made, which compensation will be favourable to the entity if the difference is negative between the principal outstanding at the time of repayment and the market value of the loan, and favourable to the borrower otherwise. The existence of that gain/loss of principal and calculation of the compensation will be determined by calculating the price of contracting for, at the time of repayment, an interest rate swap having at its main effect the maintenance for the lender of the economic value of the interest that would have accrued as from repayment, with calculation of the interest being based on the rate resulting from deducting from the fixed rate of the loan differential of 1.189%.[1]

3 At all events, the entity will be under no obligation actually to contract for any derivative instrument, insofar as that interest rate swap is merely a benchmark for calculation of the loss sustained. This measurement will be made by the entity having regard to market criteria, for which purpose the entity will request final quotations from five reference banks designated by mutual agreement between the parties (except in the event of maturity of the loan by reason of breach by the borrower) and characterised by their trading volume on the financial market, with the request that their quotations be given for the day and time on which the intended repayment takes place. […] If fewer than three measurements are obtained, it will be deemed that determination of the value payable is impracticable and the amount payable will include any loss of profit sustained by the entity increased by finance costs or, at the entity's election but without the possibility of duplication, the losses and/or costs arising from early repayment, settlement, obtainment or restitution of any related hedging or position (or any gain made in these cases). There must also be included any losses, interest or costs (or gains) in relation to any payment or delivery that ought to have been made on or before the respective early repayment date but was not so made. […]

4 The terms of this clause will also apply to early discharge of the loan through subrogation of another entity to the position of creditor of the loan in events of early repayment.

5 The content of this clause is of the essence for the contractual formation of this financing by the entity having regard to the interest rate risk incurred by this entity.

[1] Additional information: the 1,189% represents the credit risk of the borrower at inception of the loan. Fixed interest of such loans is initially estimated using a floating rate reference and adding the credit risk spread of the client at granting date. The credit risk of the borrower is not updated at prepayment as otherwise the compensation would not only reflect the economic value of interest accrued in case no prepayment is made.

Example 2:

6 (i) *Both parties declare that the duration of this loan is of the essence for the determination of the fixed interest rate for the loan, for which reason the parties expressly agree that the term of the loan has been determined for the benefit of both parties, and acknowledge that the amount of this loan may not be repaid early, whether wholly or in part, except with the consent of the entity.*[2]

7 Furthermore, the Borrower grants in advance an irrevocable waiver of the exercise of any rights or actions it might otherwise have for the subrogation of another credit institution to the legal position of the entity, subject to the exceptions and terms and conditions set out below.

8 (ii) The foregoing notwithstanding, the Borrower will have the unilateral right of subrogation and repayment of the loan provided that the market value of the loan is calculated and the portion for which the market value is positive will be compensated by the other party.

9 (iii)That market value will be determined by calculating the price of the entity contracting for, at the time of total or partial repayment, or on the date of subrogation, an interest rate swap having at its main effect the maintenance for the lender of the economic value of the interest that would have accrued as from total or partial repayment, or as from the date of subrogation. That interest rate swap will be treated as having the following characteristics:

(a) Start date: [effective date of the repayment or subrogation]

(b) Maturity date: [same as the ordinary maturity date of the loan]

(c) Notional: [amount repaid, or principal of the loan, as applicable]

(d) Fixed rate: [interest rate of the loan]

(e) Floating rate: [6-month[3] EURIBOR + 1.70%[4]]

(f) Payer of fixed rate: the entity

(g) Payer of floating rate: the reference bank

(h) Calculation periods: [those of the loan/payment dates]

(i) Floating-rate determination date: [x Business Days before the start of each Calculation Period]

10 For explanatory purposes there is added as an attachment[5] a range of scenarios of the potential consequences of early discharge of an interest rate swap. At all events, the entity will be under no obligation actually to contract for any derivative instrument, insofar as that interest rate swap is merely a benchmark for calculation of the loss sustained. the entity will make this value measurement by reference to

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[2] Additional information: According to the local legal framework, the bank can avoid the prepayment option being exercised by the other party by not providing consent to prepayment. This clause may be included in the contract or not.

[3] Additional information: The floating rate reference of *6-month* EURIBOR is the most commonly used reference for estimating the fixed interest rate of this type of loans. It is noted that this reference is also used when granting the loan to estimate the fixed interest rate to be charged to clients.

[4] Additional information: the 1,70% represents the credit risk of the borrower at inception of the loan. Fixed interest of such loans is initially estimated using a floating rate reference and adding the credit risk spread of the client at granting date. The credit risk of the borrower is not updated at prepayment as otherwise the compensation would not only reflect the economic value of interest accrued in case no prepayment is made.

[5] Not included in this paper.

market criteria, for which purpose the entity will request final quotations from five reference banks characterised by their trading volume on the financial market, with the request that their quotations be given for the same day and time as that of the early repayment or the subrogation. […]

11 In this last event, the market value of the loan will include any loss of profit sustained by the entity increased by finance costs or, at the entity's election but without the possibility of duplication, the losses and/or costs arising from early repayment, settlement, obtainment or restitution of any related hedging or position (or any gain made in these cases). There must also be included any losses, interest or costs (or gains) in relation to any payment or delivery that ought to have been made on or before the respective early repayment date but was not so made.

12 (iv) The terms of (ii) and (iii) will apply also to events of early maturity, but in this last event it will be the entity who designates the effective date of the early maturity of the loan and who calculates the market value of the loan as indicated in (iii) above.

13 (v) At all events and regardless of the method used, the amount resulting from that measurement must be settled and paid on the same date as that appointed for the repayment or subrogation.

14 (vi) If (ii) and (iii) above are held by a court to be void, this will not affect (i), i.e., the loan may not be discharged early nor may another bank be subrogated to the position of creditor of the loan except with the prior consent of the other party. The above is without prejudice to the fact that the authority to give effect to early repayment and subrogation to another bank under (ii) and (iii) <u>is simply an additional authority offered to the Borrower so that it is unharmed by the essential nature of the term of this loan</u>"

Example 3:

15 The entity (bank) or the client in events of total or partial early repayment under this Agreement and in the event of early maturity of the Agreement, independently of other potential payments in respect of interest or other agreed costs, must pay the amount due to the Party by reason of that early repayment or maturity, which will be calculated pursuant to the terms of this clause.

16 For this purpose, two business days before the date on which that early repayment or maturity becomes effective, the Bank, by telex or facsimile, must request quotations from five banks that are active on the derivatives market in relation to the estimated cost of early discharge of a transaction that exactly reflects the flows receivable by the bank in an amount and on the basis of a repayment timetable identical to that of the Agreement that has matured and been repaid in its entirety or pro rata equal to that of the partly repaid Agreement.

17 The arithmetic mean of those quotations will be calculated, ruling out the highest and the lowest, unless more than one bank quotes that same value, in which event only one of the identical quotations will be ruled out, so that there will always be three quotations serving as the basis of calculation of that arithmetic mean.

18 With the price thus obtained, the arithmetic mean referred to in the foregoing paragraph, the bank will calculate the amount payable or receivable by the client as a result of the early repayment or maturity of the Agreement, that amount being added to or subtracted from the other amounts owed by the client to the bank for other items.

19 Once the resulting amount of the early discharge has been determined in the agreed manner, the parties must make payment, according as a credit or debit balance has resulted for each one of them.

Example 4:

20 Therefore, in any of the events in which the receivables are non-existent or legitimate, whether wholly or in part, the Assignor must, a prior demand for payment having been issued by the agent or any of the assigns, pay on the tenth business day following the date of demand ("the Discharge Date"), whether to the Agent, if the demand is for the entire amount, or to the assign issuing the demand, pro rata its share, the following sums:

a) The balance, discounted to present value, of receivables as at the discharge date, calculated by means of the financial formula set out in clause X, using the mid-rate of the swaps quoted on the Y screen (or, if that screen has disappeared, the screen replacing it) on the discharge date for the various terms existing between the discharge date and the payment date of each compound interest, or, if there were no match, with multiples of 12 months, by interpolation of the immediately earlier and later terms. To the resulting interest rate there must be added a differential of 0.90% (the spread).

b) The amount sustained by the assigns to contract for, on the discharge date, a financial derivative that would compensate the assigns for the costs sustained by them to maintain and/or unwind (if the latter were practicable) the derivatives that, as set out in clause X above, they have had to enter into so as to be able to offer for this assignment the assignment price here agreed. <u>However, if the arrangement of that reciprocal financial derivative transaction earns a gain for the signs, the assigns agree to transfer that gain to the assignor.</u> In both cases this measurement will be made by each of the assigns having regard to market criteria, for which purpose the assigns will request final quotations from five reference banks designated by mutual agreement between the parties and characterised by their trading volume on the financial market, with the request that their quotations be given, as far as practicable, for the day and time of discharge or on the day closest to it. […] If fewer than three measurements are obtained, it will be deemed that determination of the value payable is impracticable and the amount payable or receivable by the assignor will include any loss of profit sustained by assigns increased by finance costs or, at the assigns' election but without the possibility of duplication, the losses and/or costs arising from discharge, settlement, obtainment or restitution of any related hedging or position (or any gain made in these cases). There must also be included any losses, interest or costs (or gains) in relation to any payment or delivery that ought to have been made on or before the Discharge Date but was not so made. At all events and regardless of the method used, the amount resulting from that measurement must be settled and paid on the same date as that appointed for discharge. It is now placed on record and the parties expressly agree that the content of this clause is of the essence to the contractual formation of this purchase of accounts receivable by the assigns executing these presents.

Example 5:

21 Early repayment. Essential nature of the term of the agreement in relation to the fixed interest rate agreed by the parties, applicable to the loan.

22 (i) Both parties declare that the duration or term of this agreement is of the essence for the determination of the fixed interest rate applicable to the loan now granted, i.e., the agreed fixed interest rate has been granted by the entity having regard to the entire agreed contractual period and on the basis that it will be fulfilled by both parties. Therefore, by mutual agreement, both parties expressly agree that the term of the loan has been determined for the benefit of both parties, and acknowledge that the amount of this loan may not be repaid early, whether wholly or in part, except with the consent of both parties.[6]

23 Furthermore, the Borrower grants in advance an irrevocable waiver of the exercise of any rights or actions it might otherwise have for the subrogation of another credit institution to the legal position as creditor of the entity, subject to the exceptions and terms and conditions set out below.

24 (ii) The foregoing notwithstanding, the Borrower will have the unilateral right of subrogation or repayment of the loan provided that (i) the market value of the loan is calculated and (ii) the portion for which the market value is positive will be compensated by the other party.

25 (iii) That market value of the loan will be equal to the price that would have to be paid by the entity if it were to contract for, at the time of total or partial repayment, or on the date of subrogation by reason of a change of creditor, an interest rate swap having at its main effect the maintenance for the lender of the economic value of the interest that would have accrued as from total or partial repayment, or as from the date of subrogation. That interest rate swap will be treated as having the following characteristics:[…]

26 For explanatory purposes there is added as attachment7 to this notarial instrument a range of scenarios of the potential consequences of early discharge of an interest rate swap. At all events, the entity will be under no obligation actually to contract for any derivative instrument, insofar as that interest rate swap is merely a benchmark for calculation of the loss sustained (or gain achieved). If the Borrower disputes the market value provided by the entity, the Borrower must give notice of such on the same day by means of a certified communication. In response to that notice of disagreement, the entity will request final quotations from five reference banks characterised by their trading volume on the financial market, with the request that their quotations be given for the same day and time as those of the early repayment or subrogation. […] If no measurements are obtained, it will be deemed that determination of the value payable is impracticable and the market value of the loan will include any loss of profit sustained by the entity increased by finance costs or, at the entity's election but without the possibility of duplication, the losses and/or costs arising from early repayment, settlement, obtainment or restitution of any related hedging or position (or any gain made in these cases). There must also be included any losses, interest or costs (or gains) in relation to any payment or delivery that ought to have been made on or before the respective early repayment date but was not so made.

[6] Additional information: According to the local legal framework, the bank can avoid the prepayment option being exercised by the other party by not providing consent to prepayment. This clause may be included in the contract or not.

[7] Not included in this paper.

27 The terms of (ii) and (iii) will apply also to events of early maturity, but in this last event it will be the entity, X who designates the effective date of the early maturity of the loan and who calculates the market value of the loan as indicated in (iii) above.

28 At all events and regardless of the method used, the amount resulting from that measurement must be settled and paid on the same date as that appointed for the repayment or subrogation.

29 (iv) If (ii) and (iii) above are held by a court to be void, this will not affect (i), i.e., the loan may not be discharged early nor may another bank be subrogated to the position of creditor of the loan except with the prior consent of the other party. The above is without prejudice to the fact that the authority to give effect to early repayment and subrogation to another bank under (ii) and (iii) is simply an additional authority offered to the Borrower so that it is unharmed by the essential nature of the term of this loan. However, the foregoing will not prevent early repayment for the reasons expressly agreed.

30 (v) Both parties acknowledge that for the determination of the fixed interest rate applicable to this loan regard has been had to the duration of the agreement, and, as a result, the entity has expectations of regular revenue inflows for interest and principal until the maturity of the loan on the basis of which it manages the interest rate risk tied to the grant of this loan together with the rest of interest rate commitments that the bank has with its customers and market counterparties.

31 If the Borrower discharges the loan early or decides to subrogate another bank to the position of the entity, the compensation referred to in (ii) above is directly linked to the economic detriment that the entity might sustain. The parties acknowledge that there is no reason for the collection of such compensation except to redress the entity for the economic detriment caused to it by termination of a contract and general exposure to interest rates at a juncture of declining interest rates, such that the other party must have its fair share of any potential gains. The above is set out in the preamble of the [Mortgage Market Act]: <u>the loan has a market value that depends on the fluctuation of interest rates, for which reason in the event of early repayment or subrogation of the loan to another bank, both losses or gains might be made, and if a gain is made it must be transferred to the Borrower</u>. The compensation of interest rate risk is precisely intended to balance obligations, and the unilateral authority given to the borrower customer to repay the loan or subrogate to other creditors has its correlate in the obligation to compensate the bank for the loss that this might cause to it.

32 The content of this clause is of the essence for the contractual formation of this financing by the entity having regard to the interest rate risk incurred by the Creditor.