

STAFF PAPER

November 2016

IFRS[®] Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IFRS 9 <i>Financial Instruments</i> —Impact of symmetric ‘make whole’ and fair value prepayment options on the assessment of the SPPI condition		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (the Interpretations Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Interpretations Committee or the International Accounting Standards Board (the Board) can make such a determination. Decisions made by the Interpretations Committee are reported in IFRIC[®] *Update*. The approval of a final Interpretation by the Board is reported in IASB[®] *Update*.

Introduction

1. The IFRS Interpretations Committee (‘the Interpretations Committee’) received a query relating to how financial assets with particular contractual prepayment options would be classified applying IFRS 9 *Financial Instruments*. Specifically, the submission asks whether a debt instrument could have contractual cash flows that meet the ‘solely payments of principal and interest’ (SPPI) condition for measurement at amortised cost if the contractual terms of the instrument include a symmetric make whole prepayment option or a fair value prepayment option.¹ A symmetric make whole prepayment option allows the borrower to prepay the debt instrument at an amount that reflects the remaining contractual cash flows of the instrument discounted at a current market interest rate. A fair value prepayment option allows the borrower to prepay the debt instrument at its current fair value. In both cases, the prepayment amount may be more or less than unpaid amounts of principal and interest (hence the reference to the term ‘symmetric’).
2. The objective of this paper is to provide the Interpretations Committee with a summary of the submission and the staff’s analysis. At this meeting, we are requesting

¹ For the avoidance of doubt, a financial asset is measured at amortised cost only if *both* of the conditions in paragraph 4.1.2 of IFRS 9 are met. However, this paper discusses only the SPPI condition.

feedback from the Interpretations Committee about the clarity of the relevant requirements in IFRS 9 and advice about how to proceed in addressing this query (including any particular factors that the Board should consider). As a next step, the staff plans to present the query to the International Accounting Standards Board (the Board), along with the feedback received from the Interpretations Committee. We will ask the Board how it would like to proceed.

Structure of the paper

3. The paper is organised as follows:
 - (a) Summary of the submission
 - (i) symmetric make whole prepayment option (paragraphs 5–9);
 - (ii) fair value prepayment option (paragraphs 10–12);
 - (b) Analysis, conclusion and questions for the Interpretations Committee (paragraphs 13–25)
 - (c) Appendix A—submission received

Summary of the submission

4. The submission notes that paragraph B4.1.11 of IFRS 9 addresses contractual terms that permit the early termination of the contract (eg prepayments). The relevant portion of that paragraph is reproduced below for ease of reference:

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:

[...]

- (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; [...]

Symmetric make whole prepayment option

5. The submission describes a contractual term that allows a borrower to prepay a debt instrument. If prepaid the prepayment amount is computed by discounting the remaining contractual cash flows of the instrument at a current market interest rate (eg reflecting the current benchmark interest rate).
6. In effect the amount prepaid is designed to allow the lender to reinvest at current interest rates and be kept 'whole'. So, if the current market interest rate is lower than the effective interest rate of the debt instrument, then the prepayment amount will be more than the unpaid amounts of principal and interest. In effect, the borrower will compensate the lender for the lender's loss of interest income resulting from the borrower's choice to prepay the debt instrument. However, if the current market interest rate is higher than the effective interest rate of the debt instrument, then the prepayment amount will be less than the unpaid amounts of principal and interest. In this case, the lender must accept a prepayment amount that effectively 'pays' the borrower to make up for the increase in the interest rate, even though the borrower chose to prepay the debt instrument. The submission asks whether the contractual cash flows arising from a debt instrument with such a 'symmetric make whole' provision are solely payments of principal and interest as described in IFRS 9 (ie whether the SPPI condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 is met).
7. The submission describes two views.

View One—the instrument may meet the SPPI condition

8. Proponents of this view assert that an instrument with the symmetric make whole prepayment option described in the submission may meet the SPPI condition. That is because they believe that if the prepayment amount is based on the remaining contractual cash flows discounted at a current market interest rate, then such an amount represents reasonable compensation for the time value of money. The proponents of this view believe that the term 'compensation' should not be interpreted

as permitting only the lender to be compensated as is the case when interest rates have decreased. Rather, proponents of this view believe it is reasonable to consider a reduction in the amount that the borrower pays to be considered ‘compensation’ if interest rates have increased, even when it is the borrower that holds the option to prepay. Further, proponents of View One note that paragraph B4.1.11 of IFRS 9 (reproduced in part in paragraph 4 of this agenda paper) sets out *examples* of contractual features that meet the SPPI condition and they argue that there is no conceptual basis for allowing one party to the contract to be compensated for the early termination of the contract but not the other party because, in all cases, the repayment amount is determined using factors that reflect only the time value of money.

View Two—the instrument does not meet the SPPI condition

9. Proponents of this view assert that an instrument with the symmetric make whole prepayment option described in the submission cannot meet the SPPI condition. They believe that the phrase ‘may include reasonable additional compensation for the early termination of the contract’ in paragraph B4.1.11 of IFRS 9 specifies that the instrument can meet the SPPI condition only if this amount is positive for the lender, ie if the borrower exercises its option to terminate the contract early, then only the lender can be *compensated* for having to accept that choice. In other words, proponents of this view argue that, if the borrower chooses to prepay the debt instrument, then a prepayment amount that is less than unpaid amounts of principal and interest (eg to reflect an increase in the market interest rate) would not meet the SPPI condition applying the requirements in paragraph B4.1.11 of IFRS 9.

Fair value prepayment option

10. The submission also describes a contractual term that allows the borrower to prepay a debt instrument at its current fair value. Similar to the symmetric make whole prepayment option described above, the fair value prepayment amount may be more or less than unpaid amounts of principal and interest. The submission observes that the fair value prepayment amount will correspond to a discounted value of the remaining contractual cash flows at a current rate that reflects a current benchmark

interest rate, a current credit spread for the borrower, and potentially a liquidity premium or profit margin.

11. The submission set out alternative views for this instrument that are similar to the alternative views described above for the symmetric make whole prepayment option. Additionally, in support of the view that this instrument may meet the SPPI condition, the submission notes that some believe that paragraph B4.1.12 of IFRS 9 indicates that a fair value prepayment option is not incompatible with the SPPI condition because such an option has minimal fair value throughout the life of the instrument.
12. Paragraph B4.1.12 states:

[...] 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.

Staff Analysis

13. Consistent with the fact patterns set out in the submission, our analysis considers only those prepayment options that are part of the *contractual terms of the financial asset*. That is because IFRS 9 requires the holder to analyse the contractual terms of a

financial asset to determine whether the asset gives rise to *contractual cash flows* that are solely payments of principal and interest on the principal amount outstanding. As explained in paragraph BC4.191 of the Basis for Conclusions on IFRS 9 the holder would not consider, for example, payments that arise only as a result of a government's or other authority's legislative powers because that power and the related payments are not *contractual terms* of the financial instrument.

14. As noted in paragraph 4 of this paper, paragraph B4.1.11(b) of IFRS 9 states that a contractual term that permits the borrower to prepay a debt instrument (or permits the lender to put a debt instrument back to the borrower before maturity) results in contractual cash flows that meet the SPPI condition if 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. Therefore, we think it is necessary to determine whether the contractual prepayment options described in the submission are consistent with the requirements in that paragraph.
15. For the purposes of this analysis, it may be useful to describe the symmetric make whole prepayment option set out in the submission as comprising both:
 - (a) a payment from the borrower to the lender for unpaid amounts of principal and interest; and
 - (b) a payment *either* from the borrower to the lender *or* from the lender to the borrower for an amount that reflects, on a present value basis, the effect of the difference between the interest rate of the debt instrument and the current market interest rate at the time of prepayment. This amount can either increase or decrease the amount described above in (a) depending on the direction that market interest rates have moved since the holder initially recognised the debt instrument (and as a result, the prepayment amount may be more or less than unpaid amounts of principal and interest).

(The fair value prepayment option set out in the submission can be 'deconstructed' in a similar manner albeit the drivers of the calculation in (b) would be different.)

16. We think the relevant question is whether the amount described in paragraph 15(b) is ‘reasonable additional compensation for the early termination of the contract’ as that phrase is used in paragraph B4.1.11(b).
17. We think the requirements in paragraph B4.1.11(b) of IFRS 9 address the fact that, in many cases, the party who exercises an option to terminate a contract before maturity may be required to compensate the ‘other’ party for having to accept that choice. As described earlier in this paper, in the fact patterns submitted, *only* the borrower holds the option to terminate the contract early. In other words, the borrower can choose to prepay the debt instrument for any reason and the lender must accept the borrower’s choice to do so. Therefore, in these circumstances, we think the requirements in paragraph B4.1.11(b) of IFRS 9 would accommodate only a situation in which the borrower (ie the party exercising its option to terminate the contract before maturity) compensates, or pays a prepayment penalty to, the lender (for having to accept the borrower’s choice).
18. The prepayment options described in the submission could have the result that the lender would receive a prepayment amount that is substantially *less than* unpaid amounts of principal and interest. In such a scenario, not only would the lender *not* receive compensation for having to accept the borrower’s choice to terminate the contract early but it could be forced to settle the contract in a way that it would not even recover its investment. We do not think that outcome meets the requirements in paragraph B4.1.11(b) of IFRS 9 and therefore we think the debt instruments described in the submission do not meet the SPPI condition.
19. We note that 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*. Specifically, paragraph AG30(g) of IAS 39 states that a call, put or prepayment option embedded in a host debt contract is not closely related to the host contract unless the option’s exercise price is approximately equal (on each exercise date) to the amortised cost of the host debt instrument *or* the exercise price of the prepayment option reimburses the lender for an amount up to the approximate present value of ‘lost interest’ for the remaining term of the host contract. IAS 39 describes ‘lost interest’ as

the product of the principal amount prepaid multiplied by the ‘interest rate differential’, which is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

20. Paragraphs BC40B–BC40C of the Basis for Conclusions on IAS 39 describe the rationale for those requirements and, in particular, note that it accommodates circumstances in which the borrower prepays a debt instrument and, as a result, must pay a penalty to the lender as compensation for loss of interest (ie to reduce the lender’s reinvestment risk). Thus, like IFRS 9, IAS 39 incorporates a notion of ‘compensation’.
21. However, while IAS 39 focuses specifically on a situation when there is a prepayment (ie by the borrower), we note that the requirements in paragraph B4.1.11(b) of IFRS 9 are not restricted to circumstances in which the borrower prepays the instrument. Rather, that paragraph also contemplates a contractual term that *permits the lender to put a debt instrument back to the borrower before maturity*. Therefore, paragraph B4.1.11(b) does not specify which party (ie the borrower or the lender) pays compensation for the early termination of the contract. As discussed above, that is because it depends on which party decides to settle the contract before maturity. If the lender exercises its option to put the debt instrument back to the borrower before maturity, it may be required to compensate the borrower for having to accept that choice. Said another way, we think ‘compensation for the early termination of the contract’ is paid *by* the party that triggers the early termination of the contract *to* its counterparty for having to accept that choice.
22. As a final observation, we note the assertion described in paragraph 11 of this paper that paragraph B4.1.12 of IFRS 9 indicates that a fair value prepayment option is not incompatible with the SPPI condition. Paragraph B4.1.12 sets out a *narrow exception* to the SPPI condition *specifically* for financial assets that meet three conditions, which are reproduced in paragraph 12 of this paper. As discussed in paragraphs BC4.187 and BC4.192-BC4.195 of the Basis for Conclusions on IFRS 9, the Board decided to provide this narrow exception to specifically address the classification of instruments

such as credit-impaired financial assets that are purchased at a deep discount and are prepayable at the contractual par amount. Accordingly, we think paragraph B4.1.12 is not relevant to the instruments described in the submission because those instruments do not meet the three conditions. We think it is inappropriate to analogise to that exception (or a portion of it).

Conclusion

23. On the basis of the analysis above, the staff thinks that neither the symmetric make whole prepayment option nor the fair value prepayment option described in the submission meets the SPPI condition. We think the objective of the requirements in paragraph B4.1.11(b) of IFRS 9 is to address circumstances in which the party that chooses to exercise its option to terminate a contract early (in the submission, this can only be the borrower) may be required to make a compensation payment to the party that must accept that choice (in the submission, this can only be the lender).
24. The prepayment options described in the submission could have the result that the lender is forced to accept a prepayment amount that is *substantially less than* unpaid amounts of principal and interest. We think that outcome is inconsistent with the requirements in paragraph B4.1.11(b) and, therefore, that the contractual cash flows of the instruments described in the submission do not meet the SPPI condition.
25. On the grounds that IFRS 9 is a recently-issued Standard that is not yet effective, we would like feedback from the Interpretations Committee about the clarity of the relevant requirements in IFRS 9 and advice about how to proceed in addressing this query (including any particular factors that the Board should consider). As a next step, we will present the query to the Board at a future Board meeting, along with feedback from the Interpretations Committee.

Question for the Interpretations Committee

Question for the Interpretations Committee

Does the Interpretation Committee have any comments or observations in relation to the clarity of the relevant requirements in IFRS 9 or advice about how to proceed in addressing this query (including any particular factors that the Board should consider)?

Appendix A

We reproduce below the submission that we received.

Suggested agenda item: Impact of symmetric ‘make whole’ and fair value prepayment options on assessment of the SPPI criterion

It has come to our attention that there are diverse views on whether a debt instrument with either a symmetric make whole or fair value prepayment option can meet the “solely payments of principal and interest on the principal amount” (SPPI) criterion for measurement at amortised cost under IFRS 9 *Financial Instruments*. As a result, we are seeking clarification of the issues detailed below by the Committee.

Issue 1: Symmetric make whole prepayment option

A 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). As the resulting prepayment amount can be higher than the par amount of the debt (if the current interest rate is lower than the contractual interest rate) or lower (if the current interest rate is higher than the contractual interest rate) this type of prepayment option is generally referred to as a “symmetric make whole provision”.

IFRS 9:B4.1.11 provides examples of contractual terms that result in contractual cash flows that are SPPI, including

...

“ (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 ”

The fact that a symmetric make whole prepayment option may result in a prepayment amount that is *lower* than the par amount of the debt may call into question whether a debt instrument with such a feature can meet the SPPI criterion.

Views

View 1: Yes. A debt instrument that contains a symmetric make whole prepayment option may meet the SPPI criterion.

IFRS 9:B4.1.11 refers to debt instruments for which 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.

If the prepayment amount is based on the remaining cash flows discounted at a current market rate, proponents of this view believe such an amount represents a reasonable compensation for the time value of money. They believe that the term “compensates” should not be interpreted as requiring only the lender to be compensated as is the case if interest rates have decreased. If interest rates have increased, it is reasonable for the borrower to be compensated.

Further, proponents of this view note that the contractual terms described in paragraph B4.1.11 are only examples of ones which would meet the SPPI criterion and argue that there is no conceptual basis for allowing one party to the contract to be compensated for early termination (without failing the SPPI criterion) but not the other party as, in the case of a symmetric make whole provision, the repayment amount is always determined using factors that reflect only the time value of money (i.e. the unpaid interest and principal and the difference between the contractual and current market rate of interest).

View 2: No. A debt instrument that contains a symmetric make whole prepayment option cannot meet the SPPI criterion

Proponents of this view read the statement in IFRS 9:B4.11 that a prepayment amount “may include reasonable additional compensation for the early termination of the contract” as specifying that this amount can only be positive for the lender (i.e. that the prepayment feature cannot compensate the borrower for movements in market rates of interest).

According to this view, make whole provisions are only acceptable when (as in the example described in paragraph B4.1.11) the amount being prepaid is floored at the par amount plus accrued interest. If the amount prepayable can be lower than the par amount, the contractual cash flows do not consist solely of payment of principal and interest.

Issue 2: Fair value prepayment option

Alternatively, the terms of a debt instrument may allow the borrower to prepay the debt instrument at an amount that corresponds to its current fair value. The fact that the instrument can be puttable at fair value may call into question whether the SPPI criterion is met.

Views

View 1: Yes. A debt instrument that contains a fair value prepayment option may meet the SPPI criterion.

The fair value of the debt instrument corresponds to the discounted value of its remaining cash flows at a current rate that includes a current benchmark rate, a current credit spread for the issuer and, potentially, a liquidity premium or margin. Proponents of this view believe that this amount can be considered to represent reasonable compensation for the time value of money. This conclusion is supported by the explanation in IFRS 9:B4.1.7A of what are the components of cash flows that represent solely payments of principal and interest on the principal.

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 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 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) [...]

Moreover, proponents note that the guidance in IFRS 9:B4.1.12 provides the following exception, for instruments that would otherwise fail the SPPI criterion only due to a prepayment option.

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.*

As such, IFRS 9:B4.1.12 allows for prepayment options that have an insignificant fair value at initial recognition. Fair value prepayment options have minimal fair value throughout the life of the instrument. Proponents of this view believe that this indicates that fair value prepayment options are not incompatible with the SPPI criterion.

Finally, as described in View 1 for symmetric make whole provisions, proponents of this view believe that the term “compensates” should not be interpreted as requiring only the lender to be compensated. Accordingly, the fact that the prepayment amount may be less than the par amount does not prevent the SPPI criterion from being met.

View 2: It depends. A debt instrument that contains a fair value prepayment option may meet the SPPI criterion only if the prepayment option includes a floor.

Proponents of this view share the views of the proponents of View 1, except that (as described in View 2 for symmetric make whole provisions) they believe that only instruments with prepayment options that compensate the lender (but not the borrower) are eligible to meet the SPPI criterion.

View 3: No. A debt instrument that contains a fair value prepayment option cannot meet the SPPI criterion.

Proponents of this view note that the fair value of debt instruments may be affected by factors not related to the time value of money (for example, changes in the issuer’s credit risk, the

liquidity risk of the instrument) and, as such, believe that fair value repayment options are incompatible with the SPPI criteria.

Reasons for the Committee to address the issue

Symmetric make whole and fair value prepayment options are common features in otherwise vanilla lending instruments. As entities prepare to adopt IFRS 9, various views are held on the question of whether such features preclude measurement at amortised cost. There is, therefore, significant risk that diversity in practice will arise, with respect to the effect of such options on the classification of the debt instruments. Further, these issues are not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that these issues meet the criteria for acceptance onto the Committee's agenda.