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Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Contractual Cash Flow Characteristics: Prepayment Features		
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Purpose and structure of the paper

1. This is the fifth paper in the series of papers for the September joint board meeting on the **solely principal and interest ("P&I") condition** in IFRS 9 *Financial Instruments*, and the FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("the FASB's proposed ASU").

2. This paper:

   (a) Provides a summary of the guidance for prepayment features in IFRS 9 and the FASB's proposed ASU;

   (b) Summarises the feedback received from both the IASB and FASB stakeholders on the assessment of prepayment features in applying the solely P&I condition;

(c) Discusses alternative approaches to classifying financial assets with the following types of prepayment features:

(i) prepayment features that result in cash flows that are solely P&I,

(ii) prepayment features that result in cash flows that are **not** solely P&I; and

(d) Provides staff recommendations and questions for the boards.

3. While this paper outlines issues and discusses alternatives in the context of the guidance for prepayment features specifically, the staff note that some of the considerations discussed in this paper, specifically consideration of the nature of any contingent trigger event and the probability of the non-P&I cash flows occurring are equally relevant to the assessment of extension features. That is because, in both IFRS 9 and the FASB's proposed ASU, the guidance for the assessment of prepayment features and extension features is consistent. Accordingly, the paper acknowledges where the proposed approaches and clarifications for prepayment features also apply to extension features.

Summary of the guidance in the FASB's proposed ASU and IFRS 9

4. The guidance on prepayment features in IFRS 9 and the FASB's proposed ASU is consistent and requires consideration of the prepayment amount and, for contingent prepayment features, the nature of the contingent trigger event.

5. Specifically, FASB's proposed ASU states the following:

> A contractual provision may either permit or require the issuer (the debtor) to prepay a debt instrument or permit or require the holder (the creditor) to put a debt instrument back to the issuer (that is, to demand repayment) before maturity. A financial asset with one of those types of contractual provisions results in contractual cash flows that are solely payments of

principal and interest on the principal amount outstanding provided that both of the following conditions are met:

(a) The provision is not contingent on future events, other than to protect either of the following:

(i) The holder against the credit deterioration of the issuer (for example, defaults, credit downgrades, or loan covenant violations) or a change in control of the issuer

(ii) The holder or issuer against changes in relevant taxation or law.

(b) 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.

6. That guidance is very similar to IFRS 9 but not identical. Specifically, the FASB's proposed ASU discusses prepayment features that either "permit *or require*" the issuer to prepay/the investor to demand repayment whereas IFRS 9 only discusses prepayment features that "permit" the issuer to prepay/the investor to demand repayment. Some could argue that contingent prepayment features that are *mandatorily* prepayable upon the occurrence of a contingent event are within the scope of the guidance in the FASB's proposed ASU outlined above, but are not within the scope of the guidance in IFRS 9. The staff acknowledge that there is a slight wording difference, however the staff believe that the guidance was not intended to apply to different populations of instruments. Specifically, the staff believe the guidance in IFRS 9 was also intended to apply to prepayment features that either "permit *or require*" prepayment and that this should be clarified.

Feedback

Prepayment amount

7. Some respondents, both those in the United States and globally, have raised questions and concerns regarding the application of the guidance on prepayment features in assessing whether the prepayment amount results in cash flows that are consistent with the solely P&I condition. Those respondents believe that the guidance on the prepayment amount will result in some financial assets that these respondents consider to be "plain vanilla" failing the solely P&I condition.

8. For example, some stakeholders note that it is common for financial assets to contain terms that require repayment of the contractually stated par amount (or par plus unpaid accrued interest) if the contract is prepaid prior to its maturity. Given the articulation of "principal" in IFRS 9 and the FASB's proposed ASU (that the staff recommend be reaffirmed in the IASB Agenda Paper 6C / FASB Memo 243), respondents noted that financial assets that are acquired or originated at a significant discount or premium to par (eg purchased financial assets with deteriorated credit quality and financial assets originated at above or below market interest rates) and are prepayable at par would likely fail the solely P&I condition and thus require classification at fair value through profit and loss (FVPL). This is because principal is understood as the amount transferred by the current holder for the financial asset (that may change over time for example to reflect repayments) and hence prepayment at the contractually stated par amount may represent *more or less than* "unpaid amounts of principal and interest…which may include reasonable additional compensation for the early termination of the contract". For example, in the extreme, if an asset were purchased at a significant discount and prepaid at par shortly thereafter, the holder's return could be well in excess of a typical interest-like return.

9. Some stakeholders note that it is also common for financial assets to contain terms that require repayment at an amount other than par if the contract is prepaid prior to its maturity. One example noted by many respondents in the United States was

a financial asset that contains a so called “make whole” provision that allows the issuer to prepay the instrument but, to do so, the issuer must pay the greater of (a) 100% of par, and (b) the sum of the present values of the remaining payments of interest and principal that would have been due if the instrument remained outstanding until maturity, discounted at a risk-free rate plus a small spread. This provision is included in the contract to make it uneconomic for the issuer to exercise the prepayment feature. For the reasons outlined in paragraph 8 above, stakeholders note that financial assets that contain such make whole provisions or other common clauses designed to protect the yield of the investor may not meet the solely P&I condition and thus would be classified at FVPL because the prepayment amount may be an amount that represents more than reasonable additional compensation for the early termination of the contract.

Nature of the contingent trigger event

10. Some stakeholders in the United States, and a few stakeholders globally, have also raised questions regarding a perceived inconsistency between the guidance on contingent trigger events discussed in the context of contingent prepayment (and extension) features and the relevant guidance for other contingent features (this is discussed in more detail in IASB Agenda Paper 6E / FASB Memo 245).

11. In addition, many respondents raised questions about which contingent trigger events could be considered consistent with “protecting the holder against the credit deterioration of the issuer”. Others gave examples of contingent events that would seem to fail the solely P&I condition in IFRS 9 and the FASB’s proposed ASU (eg an instrument is issued at par and is prepayable at par contingent on the credit *improvement* of the issuer) and asked why such contingent events should result in measurement of the entire instrument at FVPL.

Probability assessment

12. Some respondents noted that the guidance in the FASB's proposed ASU is silent on whether an entity is required to consider only reasonably possible outcomes or all possible outcomes in assessing a contingent prepayment feature. This is in contrast to the guidance on other contingent features, which specifically states that the probability of the contingent event occurring should not be considered, unless that event is non-genuine (that is extremely rare, highly abnormal and very unlikely to occur). It was unclear to those respondents whether the probability of the contingent event occurring should be taken into account when determining whether a contingent prepayment feature is consistent with the solely P&I condition.

13. Similar to concerns expressed in relation to contingent features that result in non-P&I cash flows in general, some stakeholders were concerned that a prepayment feature could result in the entire instrument failing the solely P&I condition (and thus being measured at FVPL) even if there is only a remote probability that prepayment will occur .

Staff discussion and analysis

14. The issues that the staff has identified based on stakeholders' comments can be broadly classified into three topics:

    (a) Assessment of the cash flows resulting from prepayments (i.e., the **prepayment amount**) for <u>*both*</u> contingent and non-contingent prepayment features[1],

[1] Here and throughout this paper, a contingent prepayment feature is one in which the prepayment cannot be exercised until a specified event has occurred (ie this would not include those options where the only uncertainty is whether the holder of the option will choose to exercise its option). In contrast, a non-contingent prepayment feature is one in which the option can be exercised at the discretion of the holder of the option.

(b) Consideration of the **nature of the contingent trigger event** for *contingent* prepayment features, and

(c) Consideration of the **probability of the prepayment feature being exercised** for *both* contingent and non-contingent prepayment features if the cash flows resulting from prepayment are not solely P&I.

15. It is important to clarify the point in paragraph 14(c) above. The reason that the phrase "probability of the prepayment feature being **exercised**" is used in this paper (as opposed to "probability of the contingent event occurring", as in IASB Agenda Paper 6E / FASB Memo 245) is because for contingent prepayment features that are not *mandatorily* prepayable upon the occurrence of a contingent trigger event, the actual probability of exercise (and thus, the potential impact on the cash flows of the instrument) is a dual probability event. That is, in order for there to be an impact on the cash flows of the instrument, both of the following must happen: (a) the contingent trigger event occurs, and (b) the holder of the prepayment option chooses to exercise. Therefore, the probability of the occurrence of the contingent trigger event itself is not all that matters. Specifically, what also matters is the probability that the holder of the prepayment option will choose to exercise that option if and when the contingent trigger event occurs. In this way, contingent prepayment options are different from other typical contingent features (where there is an automatic impact on cash flows once the contingent event occurs). In addition, for non-contingent prepayment options, whether the entity holding the option chooses to exercise that option is also a probability consideration. This makes non-contingent prepayment options different compared to other typical contingent features that have an automatic impact on cash flows upon the occurrence of the contingent trigger event.

16. The staff note that many of the issues discussed in IASB Agenda Paper 6E / FASB Memo 245 are also applicable to the assessment of prepayment features (e.g., consideration of (i) the nature of the contingent trigger event, (ii) the probability of the contingent trigger event occurring, and (iii) the impact of the feature on the cash flows of the financial instrument). Thus the staff analysis and

alternatives presented in this paper are consistent with the staff analysis and alternatives presented in IASB Agenda Paper 6E / FASB Memo 245. Where applicable, this paper provides references to IASB Agenda Paper 6E / FASB Memo 245 to highlight similar alternatives, issues, and decision points.

Prepayment features that result in cash flows that are solely P&I

17. This section addresses contingent *and* non-contingent prepayment features that:

    (a) Have the potential to impact cash flow variability of an instrument by more than a de minimis amount, and

    (b) Result in cash flows that are solely P&I.

18. The relevant issues to consider are whether the nature of a contingent trigger event (if any) is relevant to the assessment of prepayment features that result in cash flows that are solely P&I and if so, how the nature of a contingent trigger event should be assessed.

19. Consider the following example provided by a respondent to the FASB's proposed ASU: a financial asset is issued at par and is prepayable at par contingent on the credit improvement of the issuer. Even though the cash flows on the financial asset remain solely P&I throughout the asset's life, this prepayment feature would likely cause the asset to be considered inconsistent with the solely P&I condition under IFRS 9 and the FASB's proposed ASU because the contingent trigger event is not one that is listed in the guidance on contingent prepayment features (ie prepayment is contingent on the improvement of the issuer's credit rather than the deterioration).

20. Consistent with the analysis provided in IASB Agenda Paper 6E / FASB Memo 245, the staff believe that, amortised cost would provide relevant and useful information if the cash flows remain solely P&I throughout the life of the instrument (regardless of if/when the prepayment feature is exercised). This logic applies to both contingent and non-contingent prepayment features and is

irrespective of (a) the nature of the contingency (if any) in itself, and (b) the probability of the prepayment feature being exercised.

21. However, as explained in IASB Agenda Paper 6E / FASB Memo 245, the staff believe that there is an important interaction between the nature of the contingent trigger event and the cash flows on the financial asset – and that interaction needs to be considered in assessing a contingent prepayment feature. While the staff do not believe that the nature of the trigger event in itself should be determinative of the ultimate classification, understanding the nature of the trigger event can inform an entity's judgement as to whether the cash flows on the financial asset are indeed solely P&I and provide a simple lending type return. Said another way, an entity might not be able to entirely understand the cash flows on the financial asset unless it understands the nature of the contingent trigger event that may cause a prepayment.

22. As explained in IASB Agenda Paper 6E / FASB Memo 245, it is critical to consider both *whether* and *how* the trigger event affects the instrument's cash flows in order to determine whether those cash flows are solely P&I. If the instrument can or is required to be prepaid due to credit deterioration, that contingent trigger event in itself is not likely to introduce consideration that is inconsistent with a basic lending type return. In contrast, if the instrument can or is required to be prepaid if an equity index reaches a specified level, that contingent trigger event is expected to have an effect on the instrument's cash flows. That is, even if the *prepayment amount* is solely P&I, the price that someone would pay to invest in the instrument (or the amount of interest that would be paid on the instrument) would be expected to vary because of the contingency. This means that the contractual cash flows and the assessment of whether they are solely P&I is affected by the trigger.

23. Therefore, the staff believe that it is appropriate – and indeed necessary – to consider the contingent trigger event and the cash flows *in combination* to determine whether the contractual cash flows on the financial asset are solely P&I. In other words, all contractual provisions should be holistically considered

in classifying a financial asset. The staff believe that the application guidance on contingent prepayment features should be clarified accordingly. That is, the nature of the trigger event in itself is **not a determinative factor** in assessing whether the contractual cash flows are solely P&I throughout the life of the instrument. However, the nature of the trigger is **a helpful indicator** in assessing whether the contractual cash flows are solely P&I.

24. The staff note that this recommendation is consistent with the staff recommendation on the corresponding issue in IASB Agenda Paper 6E / FASB Memo 245. The staff also note that this clarification will result in a consistent approach to the assessment of contingent trigger events for prepayment features and other contingent features. The staff also believe that similar logic applies to contingent extension features and a similar clarification should be provided.

Question 1 for the boards
Do the boards agree with the staff recommendation that the guidance on the assessment of prepayment (and extension) features that result in cash flows that are solely P&I should be clarified as explained in paragraphs 20-23?

Prepayment features that result in cash flows that <u>are not</u> solely P&I

25. This section addresses contingent *<u>and</u>* non-contingent prepayment features that:

    (a) Have the potential to impact cash flow variability of an instrument by more than a de minimis amount; and

    (b) Result in cash flows that **<u>are not</u>** solely P&I.

26. Common examples of such non-P&I prepayments include financial assets that are originated or acquired at a significant premium or discount and can be prepaid at par, or financial assets that contain a make whole provision which provides more than reasonable additional compensation for the early termination of the contract.

27. As discussed in paragraph 8, financial assets that may or are required to be prepaid at par upon the occurrence of a specified contingent trigger event would

not meet the solely P&I condition *if* they are originated or acquired with a significant premium or discount to par.

28. A simple example may help to illustrate the concept. Consider a financial asset that is issued at par of CU100 at a market interest rate and is prepayable at CU100. That asset would be carried at CU100 in the holder's financial statements and if it is prepaid at CU100, the holder would not recognise a gain or loss. Thus the holder's return in all scenarios –regardless of whether the asset is prepaid – would represent a basic lending type return.

29. In contrast, consider a financial asset that is acquired at CU60 and is prepayable at CU100 at any time before maturity. The holder of such a financial asset would carry it in the financial statements at an amount other than CU100—and that carrying amount would be accreted to CU100. Therefore, if this asset is prepaid at CU100 immediately, the holder would realise a gain that is in excess of a basic lending type return. Hence amortised cost would not provide complete information about such an asset. Even if the financial asset is *not expected* to be prepaid (for example, because the discount on acquisition was due to credit impairment), the prepayment is *contractually possible*.

30. The staff note that a financial asset would not be measured at amortised cost in its entirety under IAS 39 *Financial Instruments: Recognition and Measurement* if it is originated or acquired at a significant premium or discount and is prepayable at par. That is, paragraph AG30(g) of that Standard states that if the exercise price of a prepayment option embedded in a debt contract is not approximately equal on each exercise date to the amortised cost of the financial asset[2], such a prepayment option must be bifurcated and accounted for separately[3].

31. Similar guidance also exists under Topic 815 *Derivatives and Hedging.* However under Topic 815 the determination of whether an embedded prepayment option

[2] Or does not reimburse the lender for an amount up to the approximate present value of the lost interest for the remaining term of the debt contract.

[3] Assuming the holder does not elect to apply the fair value option.

must be bifurcated from the host contract is often dependent upon which party holds the prepayment option.

Overview of the alternatives

32. The staff have identified the following alternatives for the boards' consideration:

(a) **Alternative A** – If the contractual cash flows that result from the prepayment feature are not solely P&I, the financial asset does not meet the solely P&I condition and will be classified at FVPL. Under this alternative, the probability of the occurrence of contractual cash flows that are not solely P&I (ie the probability of the prepayment feature being exercised) does not matter, unless the prepayment feature is non-genuine. This alternative is consistent with Alternative A in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245. This alternative is also consistent with the current guidance in the FASB's proposed ASU and with IFRS 9.

(b) **Alternative B –** The holder would be required to consider the probability of occurrence of contractual cash flows that are not solely P&I (ie the probability of the prepayment feature being exercised) in assessing a financial asset with a prepayment feature. This would apply to **all** prepayment features that could result in non-P&I cash flows **regardless of the prepayment amount**. Essentially under this alternative the current "non-genuine" probability threshold in IFRS 9 and the FASB's proposed ASU would be replaced with the lower threshold of "<u>**remote**</u>". Lowering the threshold means that (assets that have genuine non-P&I cash flows would be eligible for amortised cost if the probability of such payments are remote. If the occurrence of non-P&I cash flows becomes more likely than remote, the asset will be required to be reclassified into the FVPL category (however, to reduce complexity, reclassifications out of the FVPL category would be prohibited). This alternative is consistent with Alternative B in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245.

(c) **Alternative C** – Under this alternative, the guidance in IFRS 9 and the FASB's proposed ASU would be amended to require financial assets with prepayment features at the contractually stated par amount plus accrued and unpaid interest to be classified at amortised cost, *provided* that the fair value of the prepayment feature on initial recognition (by the current holder) is insignificant. All other prepayment features will continue to be treated in accordance with the guidance in IFRS 9 and the FASB's proposed ASU (as proposed to be modified by the staff recommendation in the preceding section of this paper). This alternative is similar to Alternative C in the non-P&I cash flows section of IASB Agenda Paper 6E / FASB Memo 245, in that it also applies to only particular types of non-P&I cash flows. This alternative also implicitly considers the probability that the non-P&I cash flows will occur because it looks to the fair value of the prepayment feature on initial recognition. This is because the fair value of the prepayment features captured under this alternative would be insignificant if prepayment is not likely to occur.

Probability assessment – general observations

33. Both Alternative A and Alternative B outlined above take into account the probability that non-P&I prepayments will occur. The former sets the probability threshold at the non-genuine and the latter sets the threshold at a lower level. In addition, as explained in paragraph 32(c), there is also an implicit probability threshold that applies to specific non-P&I prepayment features under Alternative C.

34. Consistent with the approach in IASB Agenda Paper 6E / FASB Memo 245, before discussing the alternatives in detail, the staff would like to re-iterate the implications of lowering the probability threshold—specifically, related to

establishing reclassification requirements and establishing the appropriate probability threshold for Alternative B.

Reclassifications

35. In the staff's view, if the boards decide to pursue Alternative B, which proposes to lower the non-genuine probability threshold for all non-P&I prepayment features, the boards should **require reclassification** of those instruments into the FVPL category when the probability that the non-P&I prepayment will occur increases beyond that threshold level. This is because, as discussed in Agenda Paper 6B / FASB Memo 242 for this month's meeting, amortised cost only provides useful information about financial assets with simple contractual cash flows by allocating those cash flows over time.

36. The staff do not believe that the same concerns apply to the non-genuine threshold currently used in IFRS 9 and the FASB's proposed ASU. This is due to the very nature of the non-genuine threshold. That is, a non-genuine feature can be disregarded altogether (it is essentially treated as being irrelevant) due to the extremely low probability that the non-P&I cash flows will occur.

37. In addition, the staff do not believe that reclassifications should be required – or permitted – under Alternative C. That is because that alternative already represents an exception to the solely P&I condition. In addition, the non-P&I cash flows that could result from prepayment at par (plus accrued and unpaid interest) are different from other types of non-P&I cash flows because the only element of return that is inconsistent with the solely P&I condition is the consideration for the time value of money. For example, if an instrument is acquired at a significant discount and is prepaid at par, the holder receives interest attributable to the discount at the point of prepayment rather than over time. In addition, changes in the holder's expectations about prepayment would be captured by amortised cost via catch up adjustments to the carrying value so less information content is lost than would be the case if there was greater variability in potential cash flows.

38. In contrast, if an instrument is prepayable at fair value (which could qualify for amortised cost under Alternative B if prepayment is contingent on a trigger event which has a remote probability of occurring), the return the holder *could* receive *if* the instrument does prepay could be very different from a basic lending type return. Accordingly, the staff think it is appropriate and necessary to require reclassifications under Alternative B but not under Alternative C.

39. The staff acknowledge that requiring reclassifications would add complexity to the model and impair comparability of the information provided to users. Nevertheless, the staff believe that these considerations are outweighed by the loss of information content that would occur if non-P&I cash flows were to continue to be measured at amortised cost after the probability of occurrence increases above the threshold level.

40. In addition, the staff note that the concept of monitoring a feature for changes in circumstances would not be new to the accounting in this area. For example, the staff understand that, in today's practice, embedded derivatives that technically require bifurcation and fair value measurement but have a de minimis value due to their remote nature are not recorded and accounted for separately at inception. However, these features are monitored on an ongoing basis to ensure that their value remains de minimis. To the extent that circumstances change and the value of those features becomes other than de minimis, these features are recorded and accounted for at fair value.

41. However, the staff think that if an entity has (i) reclassified the asset into the FVPL category because the probability that the non-P&I cash flows will occur has increased beyond the threshold level, or (ii) initially classified the asset at FVPL because the probability that the non-P&I cash flows will occur was beyond the threshold level, the boards should require that asset be measured at FVPL from that point forward (regardless of whether the entity subsequently concludes that the probability of occurrence has decreased below the threshold level). That is, an entity should not be required – or allowed – to reclassify the asset back and forth between FVPL and another measurement category throughout the asset's life (ie,

reclassification out of the FVPL category would be prohibited). The staff acknowledge that such an approach is asymmetrical and note that some may be concerned that this will result in a greater use of fair value. However, if such reclassifications were required – or allowed – the staff believe such treatment would dramatically impair comparability and increase complexity and would ultimately not provide useful information by allocating contractual cash flows over portions of the asset's life.

Probability threshold

42. The staff believe that the probability threshold under Alternative B should **not be lower than remote**[4]. This is because as the probability of the non-P&I contingent cash flows increases, the feature acquires a meaningful fair value and the overall return on the instrument ceases to be consistent with the notion of interest in a basic lending-type relationship and thus amortised cost would not provide useful information by allocating such return over time. Establishing a threshold lower than remote would mean that there is a real possibility that cash flows could arise that are not well captured by amortised cost measurement. Accordingly, if the boards decided to require a threshold that is lower than remote—such as more-likely-than-not, reasonably possible or probable—the staff believe that this would be inconsistent with the overall conceptual basis for classifying financial assets at amortised cost.

43. Besides, if the boards were to require a probability threshold that is lower than remote, there would be a significantly higher number of instances when reclassification would be required and reclassifications may not happen soon enough to provide timely information to users.

[4] The Master Glossary of U.S. GAAP defines remote as the chance of a future event or events occurring as slight. Remote is not defined in IFRS. The staff are not aware of any differences in interpretation of 'remote' between IFRS and US GAAP.

44. Finally, the staff note that the remote threshold is consistent with suggestions received from constituents who believed that the non-genuine threshold should be lowered.

Discussion of the alternatives and classification outcomes

45. **Alternative A** reflects the view that amortised cost is a measurement method that can only cope with simple cash flows that have low variability. If a financial asset can be prepaid at an amount other than the outstanding amount of principal and interest, that may result in an economic return in excess of a basic lending type return and hence cash flows that are not solely P&I. For such financial assets, amortised cost would not provide information to users of financial statements about the potential gain (or loss) that the holder could realise upon prepayment.

46. Alternative A would not require an assessment of the probability of exercise of the prepayment feature (other than to determine whether the feature is not genuine), nor would it require potential reclassification on that basis. This alternative and its classification outcomes are consistent with IFRS 9 and the FASB's proposed ASU. This alternative results in information about potential non-P&I cash flows that are genuine provided to users of financial statements through the fair value measurement.

47. **Alternative B** would allow more financial assets with prepayment features to be classified at amortised cost than Alternative A. For example, it would allow purchased credit impaired (PCI) financial assets that are prepayable at par to be classified at amortised cost if the probability of prepayment is remote (which staff think would often be the case for such assets). In addition, financial assets with make whole provisions that are designed to be very uneconomic such that their exercise by the issuer is remote may qualify for amortised cost under this alternative. The staff also think that Alternative B could capture contingent prepayments at fair value if the probability of the occurrence of the contingent trigger event is remote. However this alternative likely would not capture *non*-contingent prepayment features where prepayment is at fair value (as it would be

very unlikely that an entity would be able to argue that the probability that prepayment at fair value will occur is remote).

48. Similar to Alternative A, Alternative B acknowledges that amortised cost is a simple measurement mechanism that allocates interest over time and does not provide useful and relevant information about instruments with more complex cash flows; ie those that are inconsistent with the basic lending type return. However, Alternative B would accommodate all prepayment features whose exercise is remote. In those circumstances (ie where the probability of exercise is remote), it can be argued that amortised cost as a measurement basis provides useful information. That is, because the event that would cause the non-P&I cash flows is remote, there is an expectation that the cash flows will be "simple" and consistent with 'solely P&I'.

49. Alternative B applies to **all** prepayment features (i.e., contingent and non-contingent); therefore, a prepayment feature does not necessarily need to be contingent on a remote event in order for the probability of its exercise to be remote. Rather, an unfettered prepayment feature can also be considered remote if the possibility that it will be exercised is remote —which could be the case, for example, if it is very uneconomic for the holder of the prepayment feature to exercise it due to the prepayment amount.

50. Alternative B relies on the assertion that amortised cost would provide useful information because – and only as long as – the probability that the prepayment feature will be exercised is remote. Therefore, if the probability of exercise increases such that the exercise is no longer remote, amortised cost would no longer provide useful information. Hence, as noted in paragraph 28, the staff believe it would be critical for the boards to require continued monitoring of the probability of exercise and require reclassification of the financial asset into the FVPL category if the non-P&I prepayment is no longer remote. The staff believe that for Alternative B to result in useful information, the probability assessment and reclassification (where applicable) must be performed on a timely basis.

51. Some staff are concerned that since Alternative B applies to **all** non-P&I prepayment features (ie a broad population of instruments), financial assets may be measured at amortised cost even if they have features for which only fair value measurement can provide useful information. There is judgment to be applied in determining whether the exercise of a prepayment feature is “remote” (especially eg when the option to prepay is non-contingent), and some staff are concerned whether entities are able to perform this analysis (and potentially reclassify instruments if there is a change in circumstances) on a timely basis.

52. The staff also believe that the probability assessment in Alternative B would apply equally to extension features. That is, if the non-P&I cash flows that would result from an extension feature are remote, the financial asset can qualify for amortised cost treatment. If the occurrence of those non-P&I cash flows becomes more likely than remote, the asset will be required to be reclassified into the FVPL category (however, reclassifications out of the FVPL category would not be permitted).

53. **Alternative C** retains the current guidance on non-P&I prepayment features in IFRS and the FASB’s proposed ASU but provides a narrow scope exception for particular types of non-P&I prepayment features. Specifically, it requires financial assets that otherwise meet the solely P&I condition but are prepayable at par (plus accrued and unpaid interest) to be measured at amortised cost regardless of the amount transferred by the current holder for the financial asset (as adjusted for repayments and / or amortisation of the premium or discount) as long as the fair value of the prepayment feature on initial recognition is insignificant. As discussed above, in that way, Alternative C captures the remote probability of the prepayment occurring. Consistent with the analysis in paragraph 30 (and unlike Alternative B), this alternative does not require the continuous reassessment of the probability of the prepayment feature being exercised, nor does it require reclassifications.

54. Similar to Alternative B, this alternative would allow some common financial assets that do not meet the solely P&I condition under IFRS 9 and the FASB’s

proposed ASU to be measured at amortised cost. For example, PCI financial assets and other financial assets that are originated or purchased at a significant premium or discount (to the contractually stated par amount) and are prepayable at par could qualify for amortised cost.

Staff recommendation

55. Some staff support Alternative B and some staff support Alternative C. Staff members that support Alternative B believe that as long as the probability is remote that a non-P&I prepayment feature will be exercised, such a feature should not determine the classification of the entire instrument. When the probability of exercise is remote, there is an expectation that the cash flows will be "simple" and consistent with the notion of principal and interest—in which case, amortised cost will provide relevant and useful information to financial statement users about the expected cash flows of the financial instrument. These staff members acknowledge that requiring reclassifications might add complexity to the proposed guidance. However, they argue that (a) setting the threshold at "remote" would minimise the number of potential reclassifications (as "remote" is a high probability threshold for prepayment features to meet to begin with), and (b) as noted in paragraph 34, many preparers already perform the ongoing monitoring of particular bifurcatable embedded derivatives that have a de minimis fair value at inception (so the concept of ongoing monitoring of a specific feature would not be new).

56. In addition, prohibiting entities from performing a probability assessment could lead to situations where a remote feature (which has a de minimis fair value on a standalone basis) causes the entire financial asset to fail the solely P&I condition and to be classified at FVPL. In those circumstances, entities would effectively be classifying at FVPL a financial asset whose cash flows (which are used to determine the fair value measurement) meet the solely P&I condition in all but the remote prepayment scenario.

57. Other staff members support Alternative C. These staff members generally believe that classifying financial assets at amortised cost by lowering the probability threshold to remote for non-P&I features would not provide useful information—and therefore they do not support Alternative B. They also believe that measuring financial assets at other than FVPL when such assets have genuine non-P&I cash flows would be inconsistent with the boards' objective that only simple financial assets should be measured at other than FVPL. In addition to general concerns about financial assets with genuine non-P&I cash flows being measured at amortised cost, these staff members also question the practical feasibility of assessing on an individual asset level the probability that the a prepayment feature will be exercised. These staff members note that in practice the probability of prepayment is usually assessed on a more aggregated level (eg portfolio level).

58. Finally, these staff members believe the need for continuous reassessment and reclassifications, which would result from lowering the probability threshold to remote, would increase complexity and impair comparability. Those staff members also note that users are generally not supportive of reclassifications.

59. However, these staff members are sympathetic to measuring financial assets that otherwise meet the solely P&I condition and are prepayable at par at amortised cost. They acknowledge that if a financial asset is originated or acquired at a significant premium or discount to the contractually stated par amount, prepayment at par may result in an excess gain or loss to the holder that would generally be inconsistent with the solely P&I condition. However, these staff members believe that typically for these types of assets the probability that the non-P&I prepayment will occur is generally low (although genuine); notably purchased credit impaired financial assets. This consideration is reflected by the requirement that the fair value of the prepayment feature on initial recognition must be insignificant (ie rather than using an assessment of remoteness). These staff members also note that this would not lead to increased operational complexity compared to the current guidance in IAS 39 because, under that

Standard, entities are required to bifurcate such prepayment features and account for them separately at FVPL (or continuously monitor their value if they are deemed insignificant at inception).

60. In addition, these staff members note that for such financial assets the only element of the return that could be inconsistent with the solely P&I condition is the time value of money—ie because the interest represented by the premium or discount would be received immediately upon prepayment, rather than over the life of the asset. However, these staff note that the information about the holder's changing expectations about the probability that the asset will be prepaid would be captured by amortised cost via the catch up adjustment mechanism. The staff supporting Alternative C would emphasise this in the application guidance.

61. Therefore, on balance, these staff recommend measuring financial assets at amortised cost if the prepayment amount is the contractually stated par amount plus accrued and unpaid interest, regardless of the amount transferred by the holder for the financial asset, as long as the fair value of the prepayment feature on initial recognition is insignificant. All other financial assets with non-P&I prepayment features would be measured at FVPL (unless non-genuine), consistent with the solely P&I condition.

A final observation

62. Finally, the staff would like to remind the boards, as explained in paragraph 32, that Alternatives A and B outlined in this paper are generally consistent with the respective alternatives presented in IASB Agenda Paper 6E / FASB Memo 245 for cash flows that are **not** solely P&I. Alternative C is also similar to the respective alternative in that paper in the sense that it proposes an exception for particular types of non-P&I cash flows. However, more importantly, the scope of Alternative C in this paper is different from the scope of the respective alternative in IASB Agenda Paper 6E / FASB Memo 245. This is because this paper proposes an exception for those non-P&I cash flows where the only element of the return that is inconsistent with the solely P&I condition is the consideration

for the time value of money. In contrast, Alternative C in IASB Agenda Paper 6E / FASB Memo 245 captures non-P&I cash flows that can be significantly different from a basic lending type return (ie cancellation of debt or conversion into equity instruments of the issuer).

63. Accordingly, the boards may want to consider whether the decisions they make on non-P&I prepayment features discussed in this paper should be consistent with the decisions they make on other types of contingent features (discussed in IASB Agenda Paper 6E / FASB Memo 245). For example, if the boards decide to pursue Alternative B in IASB Agenda Paper 6E / FASB Memo 245 for non-P&I contingencies, they could consider whether their decision for non-P&I prepayment features in this paper should be aligned with that decision.

Question 2 for the boards

For prepayment features that result in cash flows that are **not** solely P&I, do the board members prefer Alternative A, B, or C?

Question 3 for the boards

If the board members prefer Alternative B:

1. Do the board members agree with the staff recommendation that the probability threshold for the non-P&I prepayment occurring should be established as "remote"?
2. Do the board members agree with the staff recommendation that reclassification into the FVPL category should be required if the probability that the non-P&I prepayment will occur becomes more likely than remote; however reclassifications out of the FVPL category should not be allowed?