Introduction and Invitation to Comment

The International Accounting Standards Board proposes to amend IAS 39 *Financial Instruments: Recognition and Measurement* to remove an inconsistency between paragraphs AG30(g) and AG33(a) with respect to embedded prepayment options. The proposed amendment aims to clarify that prepayment options, the exercise price of which compensate the lender for loss of interest by reducing the economic loss from reinvestment risk, as described in paragraph AG33(a), are closely related to the host debt contract.

The Board invites comments on the proposed amendment. It would particularly welcome answers to the question below. Comments are most helpful if they contain a clear rationale and, when applicable, provide a suggestion for alternative wording.

The Board is not requesting comments on matters in IAS 39 not addressed in the exposure draft.

Question

Do you agree with the proposal to amend paragraph AG30(g) of IAS 39 to clarify that prepayment options, the exercise price of which compensate the lender for loss of interest by reducing the economic loss from reinvestment risk, as described in paragraph AG33(a), are closely related to the host debt contract? If not, why?

Proposed amendment to IAS 39 *Financial Instruments: Recognition and Measurement*

In the Standard, application guidance paragraph AG30(g) is amended (new text is underlined).

Embedded derivatives (paragraphs 10–13)

…

AG30 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 11(a)) in the following examples. In these examples, assuming the conditions in paragraph 11(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.

…

(g) A call, put, or prepayment option embedded in a host debt contract or host insurance 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 carrying amount of the host insurance contract. From the perspective of the issuer of a convertible debt instrument with an embedded call or put option feature, the assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element under IAS 32. However, a prepayment option for which the exercise price compensates the lender for loss of interest by reducing the economic loss from reinvestment risk, as described in paragraph AG33(a), is closely related to the host debt contract.

…

Basis for Conclusions on Proposed Amendment to IAS 39 Financial Instruments: Recognition and Measurement

This Basis for Conclusions accompanies, but is not part of, the draft amendment.

Embedded derivatives

BC1 The Board identified an apparent inconsistency in the guidance in IAS 39 *Financial Instruments: Recognition and Measurement*. It relates to embedded prepayment options in which the exercise price represents a penalty for early repayment (ie prepayment) of the loan. The inconsistency relates to whether these options are considered as closely related to the loan.

BC2 The Board decided to remove this inconsistency by amending paragraph AG30(g) of IAS 39. The proposed amendment makes an exception to the examples included in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise price of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.