This article aims to:
- Demonstrate the assessment of the classification of financial instruments with prepayment features and determine when compensation is considered ‘reasonable’.

**Background**

Indian Accounting Standard (Ind AS) 109, *Financial Instruments*, prescribes that financial assets should be classified and subsequently measured at amortised cost, Fair Value Through Other Comprehensive Income (FVOCI) or Fair Value Through Profit or Loss (FVTPL) on the basis of the entity’s business model for managing financial assets and its contractual cash flow characteristics. For assets that are in a ‘hold-to-collect’ or ‘hold-to-collect and sell’ business model, entities need to assess whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are Solely Payments of Principal and Interest (SPPI).

Ind AS 109 states that for the purpose of the contractual cash flow characteristics test, the ‘principal’ is the fair value of the asset on initial recognition, and may change over time – for example, when there are repayments of principal. ‘Interest’ is consideration for the time value of money and credit risk, and can also include consideration for other basic lending risks and costs, and a profit margin.

The contractual cash flows of some financial assets may change over their lives. For such assets, an entity determines whether the contractual cash flows that could arise both before and after the change in contractual cash flows meet the SPPI criterion - for example financial assets with variable interest rates, prepayment features or extension options.

In this article, we aim to illustrate the SPPI assessment performed for loans with prepayment features in order to ascertain their classification and subsequent measurement.
Example: Loans with prepayment option

Bank C (the bank) provides banking and other financial services to both retail and corporate customers. On 1 April 2019 it advanced a housing loan to Mr. A, a retail banking customer and a term loan to P Private Limited, a corporate banking customer. The key features of the loans are given hereunder:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Housing loan</th>
<th>Term loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of loan</td>
<td>INR4,000,000</td>
<td>INR50,000,000</td>
</tr>
<tr>
<td>Interest rate</td>
<td>8.95 per cent</td>
<td>12.5 per cent</td>
</tr>
<tr>
<td>Effective Interest Rate (EIR) of the loan</td>
<td>9.5 per cent</td>
<td>13.4 per cent</td>
</tr>
<tr>
<td>Period of loan</td>
<td>10 years</td>
<td>Five years</td>
</tr>
<tr>
<td>Repayment term</td>
<td>The loan would be repaid by way of an Equated Monthly Instalment (EMI) of INR50,562 over a period of 10 years.</td>
<td>The loan would be repaid in five annual installments beginning 31 March 2020</td>
</tr>
<tr>
<td>Prepayment clause</td>
<td>Prepayment is not permitted for the first six years of the loan. Prepayment made post that, would require the customer to pay an additional charge of 0.25 per cent on the principal amount repaid.</td>
<td>Prepayment is permitted after the company has paid the second annual instalment. Five per cent of the nominal amount of loan would be paid as bank fee.</td>
</tr>
<tr>
<td>Business model of the loan</td>
<td>Held-to-collect</td>
<td>Held-to-collect and sell</td>
</tr>
</tbody>
</table>

As per its policy, Bank C invests its excess cash in government securities, this includes amounts received from customers on prepayment of loan. It expects the government bond rates with maturity of one to three years to bear an interest rate of 6.25 per cent per annum.

A fee between 1.5-3.5 per cent of the prepaid amount is generally collected by the bank as compensation for early repayment, to cover administration costs.

Accounting issue

On original recognition of the loans advanced (the financial assets), Bank C needs to undertake a comprehensive review of the loan documentation to assess whether the contractual cash flows that arise over the life of the loans meet the SPPI criterion. If the SPPI criterion is met, then the housing loan and term loan would be classified and subsequently measured at amortised cost and at FVOCI respectively. In case this criterion is not met, then the loans will be classified and measured at FVTPL.

Accounting guidance

As per Ind AS 109, financial instruments with prepayment features may change the timing or amount of contractual cash flows, however, they may meet the SPPI criterion under certain conditions as given in figure 1 below:

Figure 1: Prepayment features that meet the SPPI criterion

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1. The prepayment fees considered in this illustration may not represent the current industry practice, and have been adopted for illustrative purposes only.
2. This interest rate is not representative of the current market, and has been assumed for the purpose of the illustration.
3. In October 2017, the International Accounting Standards Board (IASB) made a limited scope amendment to International Financial Reporting Standard (IFRS) 9, Financial Instruments with which Ind AS 109 is aligned. The amendment specifies that the compensation for early termination of the contract should be ‘reasonable compensation’, and may not be additional. A similar amendment has been proposed to be made in Ind AS 109 by way of an exposure draft issued by the Institute of Chartered Accountants of India (ICAI) on 12 June 2018.
Analysis

Bank C needs to first evaluate the nature of the prepayment feature. It also needs to consider what the prepayment amount would be at each date on which the prepayment feature is exercisable, to determine for all cases whether the prepayment amount substantially represents ‘unpaid amounts of principal and interest’.

Housing loan

Prepayment of the housing loan is permitted post the sixth year, accordingly, for the purpose of evaluation, we may consider that the loan is prepaid at the end of year seven, eight and nine. In each case, the amount paid would include the principal amount outstanding on the date of prepayment and a fee, as given in the loan agreement.

As per Ind AS 109, a prepayment feature whose 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 meets the SPPI criterion. Accordingly, Bank C needs to evaluate the purpose for which the fee is collected. An evaluation of this has been presented in table 1 below:

Table 1: Evaluating prepayment features of housing loan

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Amounts at the end of the (Amount in INR in thousands)</th>
<th>Seventh year</th>
<th>Eighth year</th>
<th>Ninth year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal amount repaid</td>
<td></td>
<td>1,591</td>
<td>1,107</td>
<td>578</td>
</tr>
<tr>
<td>Additional charge</td>
<td></td>
<td>4</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total amount paid by borrower (A)</strong></td>
<td></td>
<td><strong>1,595</strong></td>
<td><strong>1,110</strong></td>
<td><strong>580</strong></td>
</tr>
<tr>
<td>Principal amount outstanding</td>
<td></td>
<td>1,591</td>
<td>1,107</td>
<td>578</td>
</tr>
<tr>
<td>Add: Present value of earnings foregone (at coupon rate)</td>
<td></td>
<td>199</td>
<td>95</td>
<td>26</td>
</tr>
<tr>
<td>Less: Present value of notional interest earned (discounted at EIR of the loan)</td>
<td></td>
<td>(250)</td>
<td>(121)</td>
<td>(33)</td>
</tr>
<tr>
<td><strong>Amount expected to be received by bank (B)</strong></td>
<td></td>
<td><strong>1,540</strong></td>
<td><strong>1,081</strong></td>
<td><strong>571</strong></td>
</tr>
<tr>
<td>Excess amount paid by borrower (A-B)</td>
<td></td>
<td>55</td>
<td>29</td>
<td>9</td>
</tr>
<tr>
<td>Excess amount paid as a percentage of principal outstanding</td>
<td></td>
<td>3.4%</td>
<td>2.6%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Source: KPMG in India’s analysis, 2018

A. Total amount paid by borrower

Amounts paid by the borrower at the end of years seven, eight and nine represent the principal amount as on those dates, and an additional 0.25 per cent fee on the principal amount prepaid, as mentioned in the loan agreement.

B. Compensation to be received

The amount expected to be received by the bank on prepayment of the loan includes the principal amount outstanding on the date of prepayment and other amounts to cover its notional loss on prepayment. This includes:

- Present value of earnings foregone: This represents the amount that the bank would have earned, had the borrower continued to hold the loan as per its original tenure. It is calculated at the coupon rate of the loan and represents the interest foregone on account of prepayment of the loan. This amount is discounted at the EIR to represent the present value on the date when the prepayment is expected.

- Present value of notional interest earned: As per the bank’s policy, excess cash, including prepayments of loans received, are invested in government bonds. Accordingly, the present value of the total compensation expected to be received by the bank would reduce to the extent of the present value of the notional interest earned on the government bond at the EIR of the loan.

4. The present value of the notional interest earned would be computed by discounting the notional interest earned on the government bond at the EIR of the loan.
The amount paid by the borrower is higher than the expected compensation. The bank needs to evaluate whether the additional compensation paid by the borrower is ‘reasonable’\(^5\). While Ind AS 109 does not define what is considered to be ‘reasonable’, it states that under a basic lending arrangement, SPPI is met, when interest compensates an entity for:

- Time value of money
- Credit risk associated with the principal amount outstanding
- Other basic lending risks (for example, liquidity risk)
- Costs (for example administrative costs) associated with holding the financial asset for a particular period of time, and
- A profit margin.

In the above case study, since the excess amount received is within the range of 1.5 – 3.5 per cent of the prepaid amount, which, as given in this illustration\(^6\) is generally collected by Bank C for administration fees, it meets the SPPI criterion, since it compensates the bank for meeting certain costs associated with the loan. Since the SPPI criterion is met, and the asset is held under a business model of ‘hold-to-collect’, it is classified and subsequently measured at amortised cost.

### Term loan

A similar analysis is performed for the term loans issued by the bank, where the prepayment amount is assessed on each date when the prepayment is exercisable.

In the above case study, the additional compensation in year two is within the range of administration fees generally collected by the bank. However, this criteria should be met at every prepayment date of the instrument. Accordingly, this needs to be assessed for prepayment at the end of year three and four. Since the amounts paid by the borrower at the end of years three and four would exceed the amount that the bank generally collects as its administration costs, the additional compensation paid by the borrower includes compensation for other factors. This may not substantially represent ‘unpaid amounts of principal and interest’ and thus may not be considered to be ‘reasonable’ in the context of this illustration. Since the SPPI criterion is not met, the term loan will be classified and measured at FVTPL.

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\(^5\) Since the term ‘reasonable’ has not been defined by Ind AS 109, assessment of whether the compensation paid by the borrower meets this criteria is highly judgemental. Entities should consider both qualitative and quantitative factors when performing this assessment.

\(^6\) Every entity would be required to evaluate this based on the facts and circumstances of their condition.
Consider this

• On the date of prepayment of the loan, the unamortised processing fees should be charged to the statement of profit and loss.

• Determining ‘unpaid amounts of principal and interest’ requires consideration of the economic characteristics of the contract and may require judgement. In particular, it may be necessary to determine whether individual cash flows required by the contract (in the absence of the prepayment feature) represent payments of interest or repayments or advances of principal and how rights to interest are considered to arise over time. For example, for assets that are originated or purchased at a premium above the par amount repayable on maturity, contractual coupons (i.e. what the contract labels as interest) may represent in part repayments of principal for the purpose of evaluating the SPPI criterion.

• If a financial asset would otherwise meet the SPPI criterion, but fails to do so only as a result of a contractual term that permits or requires prepayment before maturity, or permits or requires the holder to put the instrument back to the issuer, the asset can be measured at amortised cost or FVOCI if:
  - The relevant business model condition is satisfied
  - The entity acquired or originated the financial asset at a premium or discount to the contractual par amount
  - The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for early termination, and
  - On initial recognition of the financial asset, the fair value of the prepayment feature is insignificant.

• Assessment of what is considered as ‘reasonable’ compensation may differ depending on whether prepayment is at the option of the borrower or lender.

• In October 2017, IASB made limited scope amendments to IFRS 9, allowing particular financial assets with prepayment features that may result in negative compensation- e.g. the lender receives less than the par amount and accrued interest and effectively compensates the borrower for the borrower’s early termination of the contract- to be measured at amortised cost or at FVOCI (subject to business model assessment). Before the amendments, these instruments were measured at FVTPL because the SPPI criterion would not be met when the party that chooses to terminate the contract early may receive compensation for doing so.

The amendments have also removed the requirement for the compensation to be ‘additional’. Accordingly, a prepayment amount that is less than the unpaid amounts of principal and interest (or less than the contractual par amount plus accrued interest) may meet the SPPI criterion if it is determined to include reasonable compensation for early termination.

Similar amendments have been proposed to be made in Ind AS 109, as per the exposure draft of the amendments to Ind AS 109 issued in June 2018.