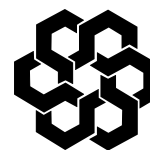

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **13 December 2006, London**

Project: **Financial Instruments – Due Process Document (DPD)**

Subject: **Recognition and Measurement (Agenda Paper 12A)**

BACKGROUND

1. At the last meeting, the IASB discussed the measurement of certain contractual financial instruments whose cash flows depend upon whether the other party to the contract exercises an option that would be beneficial to the entity.

2. The IASB agreed that transactions involving the transfer of credit card portfolios provide evidence that an asset exists for the credit card company that holds the credit card contracts – although the IASB did not reach a decision whether the credit card company's ability to benefit from such contracts is best viewed as the right to benefit from an existing contract, or as part of an existing customer relationship.

CONTENTS OF THIS PAPER

3. This paper discusses:

    a. How the measurement of a loan with a prepayment option should be characterized from the holder's perspective

    b. How the measurement of a credit card contract should be characterized from the credit card company's perspective

4. The appendix contains a brief analysis of both the loan with the prepayment option and the credit card contract using the latest draft of the proposed definition of an asset in the Conceptual Framework project.

IS THERE AN ASSET?

5. There has been no dispute so far that some form of asset exists for the credit card company relating to the credit card agreement. Likewise for the loan with a prepayment option for the holder of the loan. This is evidenced by the transactions which occur and that relate to (if not directly, then at least indirectly) to the contract that currently exists.

6. This paper is therefore primarily asking the question of whether there are two different kinds of value in such an asset (or in the case of credit card contract, an asset and a liability) and, if so, whether the two should be separated.

7. It may be that Board members wish to label some or all of the value of this type of asset as an 'intangible' value (which may or may not be recognized). However, it is important that Board members understand the difference between this value and intangible assets (for example, goodwill) and the assets we are discussing in this paper.

LOAN WITH PREPAYMENT OPTION

Background

8. In the discussion of the measurement of certain contractual financial instruments whose cash flows depend upon whether the other party to the contract exercises an option that would be beneficial to the entity, paper 5C presented at the last IASB meeting asked how a loan that is prepayable should be measured.

9. The borrower, under the terms of the contract, has the right to repay the loan in whole or in part at any time it chooses before its stated contractual maturity. The stated monthly payment requirement actually is a minimum payment. That is, the borrower holds a call option over its own debt with an exercise price equal to the amount of unpaid principal and interest.

10. One reason that borrowers would exercise an option to call back a loan (prepay) is that they are able to re-issue the loan (or refinance) on similar terms at a more beneficial rate; that is, when market interest rates on comparable loans are below the interest rate on the existing loan instrument. (That motivation is similar to the motivation to exercise an in-the-money stock option.) If that were the only consideration, the borrower would always exercise its call option when market rates are below the contract rate and would never exercise that call option if market rates are not below the contract rate.

11. Obviously, however, there are many other factors that affect a borrower’s decision about whether or not to prepay. For example, a borrower decide to prepay even though it cannot refinance at a lower rate because may want to sell the collateral property or may have free cash that it cannot invest at a rate higher than the contract rate on the loan. A borrower may decide not to prepay when it could refinance at a lower rate because the time and effort required to refinance may make refinancing undesirable from the borrower’s viewpoint. If the borrower is an unsophisticated consumer, that borrower may not even be aware that current market interest rates are lower than the contract rate.

12. Market participants who hold prepayable loans as assets or are considering investing in prepayable loans ('market participants') consider all outcomes with nonzero probabilities. These possible outcomes will include prepayments and non-prepayments due to factors other than interest rates.

13. The U.S mortgage loan secondary market is deep and liquid, and price quotes are available daily for loans of different terms and to borrowers with different demographics. That market demonstrates unequivocally that investors base their prepayment assumptions on historically verifiable borrower behavior (prepayment speed statistics). To reiterate, fair value is based on observed prices, and observed prices of prepayable loans clearly include the effects of borrower prepayment behavior that the lender cannot compel and would not expect based purely on interest rates.

14. That analysis raises the following question: Should investors separately report the portion of the value of those prepayable loans that would not exist if borrowers were expected to exercise their options based solely on interest rates?

15. Reporting the entire fair value of the prepayable loan as a single number would be consistent with the prices that market participants would set for the loan in any transfer. Such an approach would also be consistent with the notion that the holder of the loan controls the contract, and can transfer the contract in a sale transaction.

16. Reporting a portion of the value of the loan separately as a customer relationship intangible (or other nonfinancial value) would require that:

    a. We describe the part of the fair value of the loan that relates to the customer relationship

    b. Assuming that the part of the loan labeled as a customer relationship is recognized, we would also need to decide whether (for practical or other purposes) that part is recognized and, if so, whether it is measured together with the part labeled as the right to benefit from an existing contract.

17. Separating the nonfinancial part of the fair value of the loan would not necessarily be easy to do because some of the assumptions used in pricing stock options cannot be applied. For example, the assumption that a stock option will not be exercised until the expiration date because doing so sacrifices some time value clearly does not apply to the prepayment option. The prepayment option does not expire until the loan is prepaid in full, at which time, it has no value anyway. A different set of assumptions might have to be developed for each different type of prepayable loan. One particularly difficult assumption to develop would be an interest rate "volatility" analogous to the stock price volatility in a stock option pricing model.

18. The financial portion of the fair value of a prepayable loan would never be greater than the unpaid principal and interest balance. A value greater than the unpaid balance could only occur if the borrower's market interest rate was less than the contract amount, and if that were so, the borrower "should" have repaid. Therefore, one way to separate would be to declare any value over the contractual amount due to be nonfinancial. However, that would be an imprecise estimate because the actual financial value based on interest rate volatility could easily be less than the unpaid balance. It is not clear what incremental benefit such a separation would provide to users even if it could be done precisely.

19. Describing part of the value of the loan as a nonfinancial value would not be consistent with the price set by market participants for the loan. Since market participants set a single price and do not identify portions as financial or nonfinancial, it could not be based on market evidence.

20. The argument for separating a portion of the value and reporting it as nonfinanical is based on the fact that the holder of the loan cannot compel the borrower to exercise or refrain from exercising the prepayment option. Said differently, a written option can only be a liability, because the prepayment option imposes an obligation on the holder of the loan asset. Under that theory therefore, any positive value of the prepayment option is not part of the value of the contractual

asset[1]. Only those possible outcomes that result in an economic burden for the loan holder should be considered in estimating the financial portion of the fair value of the loan asset.

Alternatives

21. The staff has identified the following four alternatives for resolving the prepayable loan issue:

    a. Recognize the asset at fair value and report it as a financial instrument. That would be justified by saying that the asset is the value of a financial instrument and the reasons why the value arose are not a distinguishing factor.

    b. Recognize the asset at fair value and report it as a financial asset. That would be justified by saying that most of the value arises because of the amount payable; the nonfinancial portion is likely to be immaterial and the effort to separate it is not worth the benefit to users.

    c. Recognize the fair value of the contract in two separate parts—a financial asset and a nonfinancial asset. The justification would be similar to alternative (b) except that the benefit of separating the nonfinancial portion is worth the cost.

    d. Recognize only the financial portion of the asset. The justification would be that the nonfinancial portion of the value is outside the scope of a standard on financial instruments.

22. **Questions to the Boards:**

    a. **Are you prepared to express a preliminary view on recognizing and measuring prepayable loans and other instruments with similar features? If so, which alternative do you support?**

[1] See appendix.

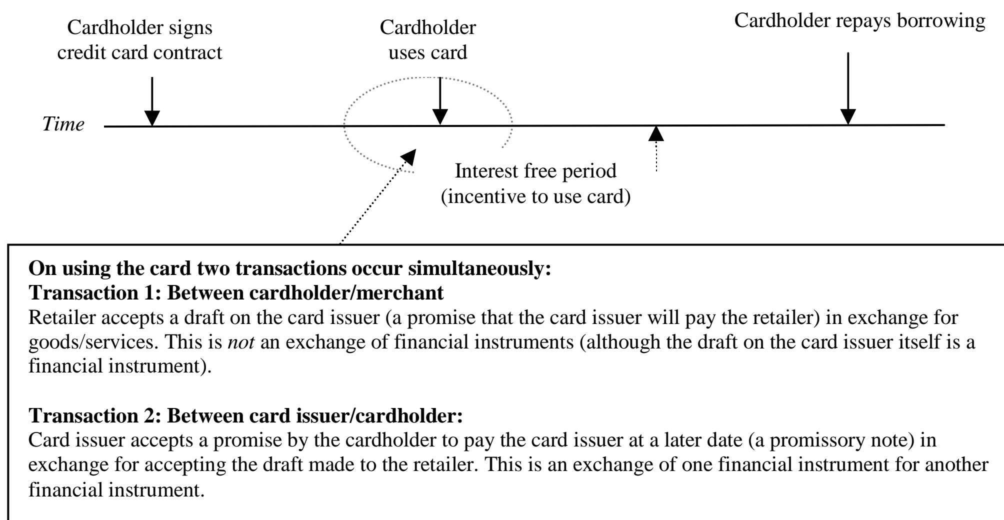
b. **If you are not prepared to express a preliminary view but believe you could express a preliminary view if the staff provided additional information, what additional information do you need?**

CREDIT CARD AGREEMENT

Background

23. To avoid confusion over *what* we are trying to measure in the credit card contract, we believe it worthwhile to set out in detail the example of the option a credit card company writes to the holder of the credit card.

24. The following diagram provides a chronological representation of this option of borrow when the cardholder uses the card to purchase goods or services from a third-party retailer (the cardholder's option to "put" its own debt instrument to the card issuer in exchange for a payment directly to a merchant)[2] .



25. The credit card contract sets outs the terms of the promissory note (that is, the terms under which the cardholder can borrow money). Such terms might include

[2] A card holder can also normally use the card to obtain cash advances from the card issuer. Such a cash advance would be an exchange of cash for a promise by the card holder to repay the credit card company. This exchange would meet the definition of a financial instrument.

an interest-free borrowing period as well as the right by the cardholder to extend the payment periods. However, it is important to note that we are not, in this paper, seeking to measure the promissory note itself (which includes an option very similar to the option in the prepayable loan described in the previous section of this paper).[3]

26. In this paper we are addressing the expectation that exchanges of promissory notes from the card holder for drafts on the issuer made out to the retailer will occur, and if such exchanges occur then the fair value of those exchanges (namely the expectation and value of transaction 2, as set out above, occurring).

27. The credit card company also has a contractual agreement with the retailer[4]. The agreement with the retailer sets out the *payment terms* for any drafts on the card company that are accepted by the retailer when the card holder uses the card. Such payment terms usually include what is called an interchange fee, which means that the retailer who accepts the card receives less than face value when it presents the draft to the card company for payment. The typical discount is a few percentage points.

28. Interchange fees reduce the cash outflows of the credit card company relating to settlement of the draft, making the exercise of the option to borrow by the card holder economically attractive to the card company even if the cardholder pays immediately and incurs no interest charges. The interchange contract, which is between the retailer and a bank affiliated with Visa, MasterCard, or another card sponsor, has little or no value by itself. It is simply an agreement to participate in the card sponsor's network. Such contracts are available to any retailer or other merchant that meets predetermined criteria and agrees to follow the sponsor's processing requirements. Thus, those contracts are not scarce resources that result in assets or liabilities.

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[3] The credit card receivable requires a minimum payment computed using an implied term of several years, but the cardholder is permitted to pay in full at any time.

[4] In reality, the agreements will actually be between a company such as Visa or MasterCard and the retailer, with another agreement between the card issuer and a company such as Visa or MasterCard.

The Issue

29. Credit card contracts are occasionally transferred by one card issuer to another, and in all cases we are aware of, the issuer receiving the contracts pays the issuer giving up the contracts. Consequently, the only reasonable conclusion to draw is that the fair values of the contracts are positive which means they are assets. Because conventional thinking about options such as stock options might lead us to believe that written options can only be liabilities, that observation raises the same question raised by prepayable loans.

30. Although the issue with credit card contracts is similar to the issue with prepayable loans, the potential nonfinancial value of a credit card contract is much more significant. In fact, if a financial/nonfinancial split were applied to a credit card contract, the result would be a financial liability and nonfinancial asset. Cardholders usually use their cards (exercise their option to borrow) when interest rates on other loans with comparable terms are lower than the contractual rate on borrowings under the card. Thus, nearly all of the fair value of a credit card contract would be considered nonfinancial.

31. That discussion raises the following question:

    Should card issuers separately report the portion of the value of a credit card contract with a cardholder that would not exist if cardholders were expected to exercise their options based solely on interest rate considerations?

32. Reporting the entire fair value of a credit card contract as a single asset arising from the right to benefit from an existing contract would be consistent with the notion that the holder of the credit card contract controls the contract, and can transfer the contract in a sale transaction. The contract clearly gives rise to an asset of the card issuer that appears to be viewed as a single asset by market participants.

33. Separating the value of the credit card contract into a financial liability portion and a nonfinancial asset portion would require the Boards to establish standards to

identify the financial liability (the difference between that and fair value would be the nonfinancial asset). It would also require card issuers to implement the necessary systems to gather the required data to make the computation.

34. Separating the fair value of the credit card contract into a nonfinancial asset portion and a financial liability portion would be consistent with the argument that, because the holder of the asset cannot compel the cardholder to exercise its option to borrow, and the cardholder does not borrow solely because of interest rates, then any economic benefit attributed to that exchange transaction is not a financial asset.

Alternatives

35. The staff has identified the following four alternatives for resolving the credit card contact issue:

    a. Recognize the asset at fair value and report it as the fair value of a financial instrument. That would be justified by saying that the asset is the value of a financial instrument and the reasons why the value arose are not a distinguishing factor.

    b. Recognize the asset at fair value and report it as a nonfinancial asset. That would be justified by saying that most of the value arises because of exercises of the option for reasons other than interest rate considerations and therefore, the value is nonfinancial even though it is associated with a financial instrument. The liability portion is likely to be immaterial and the effort to separate it is not worth the benefit to users.

    c. Recognize the fair value of the contract as two separate parts—a financial asset and a nonfinancial liability. The justification would be similar to alternative (b) except that we do not know whether the liability portion would be immaterial and the benefit of separating is worth the cost.

    d. Do not recognize the asset or the embedded liability portion. That would be justified by saying that because most of the fair value is nonfinancial

and the financial liability portion is likely to be immaterial, it is not within the scope of a standard on financial instruments.

Questions for the Boards:

a. **Are you prepared to express a preliminary view on recognizing and measuring credit card contracts and other instruments with similar features? If so, which alternative do you support?**

b. **If you are not prepared to express a preliminary view but believe you could express a preliminary view if the staff provided additional information, what additional information do you need?**

c. **If your preliminary view on credit card contracts is different from your view on prepayable loans, what is the reason for the difference?**

APPENDIX

1. This appendix analyses the loan with a prepayment option and the credit card contract in terms of the continuing discussions in the Conceptual Framework project on the draft definition of an asset (and, by inference, to the draft definition of a liability yet to be discussed by the Boards).

Background

2. The key relevant points arising from the discussion of the draft definition of an asset for the purposes of this analysis are:

    a. The asset itself is a present economic resource. An economic resource is something that has positive economic value. This includes an unconditional promise in a contract that has positive economic value.

    b. An entity is linked to an economic resource by a present right (that is legally enforceable or enforceable by equivalent means) or other privileged access.

Loan with a prepayment option

The unconditional promises in the contract

3. The unconditional promise relating to the prepayment option can be characterized as the promise from the holder of the loan to accept prepayment by the borrower on the terms specified in the loan instrument.

The rights and obligations linking the holder to the promise

4. The borrower has made no unconditional promise to the holder of the loan in relation to the prepayment option (and therefore the question of whether the holder is linked to a promise by the borrower by way of rights is not relevant). Any economic benefit to the holder of the loan related to the promise identified above would therefore not arise from the promise in the contract.

Credit card contract

The unconditional promise in the contract

5. A credit card contract can be characterized as consisting of a promise by the card issuer to accept a draft to pay a third party (the retailer) in exchange for a promissory note from the card holder.

The rights and obligations linking the credit card company to the promises

6. The card holder has made no unconditional promise to the card issuer (until the card is used). Therefore the question of whether the card issuer is linked to a promise by the card holder by way of rights is not relevant. Any benefit attributed by market participants related to this promise would therefore not arise from the promise in the contract.

7. The card issuer is, however, linked to the promise set out above by way of an unconditional *obligation* (the card holder can direct, manage or exercise power over the promise), and therefore if there is any economic burden linked with this obligation a 'contractual' liability would be recognized (for example, the possible outcomes set out in paragraph 30 of the main paper).