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**International
Accounting Standards
Board**

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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: 18 September 2006, London

Project: Consolidations (including special purpose entities)
[Education Session]

Subject: Education Session: Scenarios Involving Entities within the
Scope of SIC-12 (Agenda Paper 7C)

1. [Beginning of paragraph omitted from observer note]. These examples illustrate typical transaction structures. In these examples, monetary units are referred to as 'currency units' (CU).
2. The cases are as follows:
 - Case 1 – Asset-backed Securitisation Transaction
 - Case 2 – Collateralised Debt Obligation
 - Case 3 – Synthetic Lease Structure
 - Case 4 – Multi-seller Conduit

Case 1: Asset-backed Securitisation Transaction

3. A corporation (Transferor) has appreciated but volatile debt securities. In a conventional two-step structure it first transfers CU500 million in fair value of such securities to a wholly owned corporation (SPE 1). SPE 1 then transfers all of the securities into a separate legal entity (SPE 2). SPE 2 issues CU200 million of commercial paper: CU190 million is paid to SPE 1, and CU10 million is used by SPE 2 to purchase a put option covering market value declines in the CU500 million of securities below CU190 million. SPE 1 retains a CU300 million subordinated interest in the securities in SPE 2.
4. SPE 2 is managed by a private advisory firm (Advisor) unrelated to the Transferor. The Advisor receives a small fixed fee plus a variable fee equal to five percent of the appreciation in the pool of transferred securities over CU500 million. Within specified but flexible parameters, the Advisor is able to sell the securities in the SPE based on its best judgment of the market.

Case 2: Collateralised Debt Obligation – Base Facts

5. An offshore corporation (CDO entity) issues CU80 million of investment grade debt securities, CU15 million of non-investment grade debt securities, and CU5 million of preference shares and uses the proceeds to acquire various debt securities of predetermined types, credit ratings, and maturities. The securities issued by the CDO entity are referred to as collateralised debt obligations. All losses are incurred first by the preference shareholders, then by the non-investment grade debt holders, and then by the investment grade debt holders. The holders of the CDO entity's debt securities and preference shares have some voting rights (eg, they can remove the collateral manager with or without cause). The CDO entity has no other activities. The outstanding common stock of the CDO entity is nominal in amount, is held by a charitable trust, and has no voting rights. The charitable trust that holds the CDO entity's common stock is not a related party of any of the other parties involved with the CDO entity.
6. The parties involved with the CDO entity include the following:
 - (a) The collateral manager who services the debt securities held by the CDO entity. The collateral manager monitors the debt instruments held by the CDO entity and makes decisions about buying and selling those securities based on predetermined criteria. It receives a senior fee of 20 basis points per annum (based on the market value of the investments held by the CDO entity), a subordinate fee of 25 basis points per annum, and an incentive fee of 20 basis points per annum; all of these fees are market based. The collateral manager can be removed by a vote of two-thirds of the holders of the debt securities and preference shares issued by the CDO entity.
 - (b) The holder of the common stock who receives a nominal fee for facilitating the existence of the CDO entity and has no voting rights.
 - (c) The holders of the debt securities issued by the CDO entity who have the right to receive specified amounts of cash at specified times. Because of their senior interest in the cash flows of the CDO entity, the holders of investment grade debt securities bear very little risk and consequently, receive a lower rate of return than the holders of the non-investment grade debt securities and the preference shares. The holders of the non-investment grade debt securities also have rights to receive contractually specified payments. However, their interests are subordinated to the interests of the holders of the investment grade debt securities, and

consequently, they bear a greater risk of loss and will receive a higher contractual rate of return. Neither class of debt securities imposes obligations on the holders to provide additional funds for the CDO entity.

- (d) The holders of the preferred stock issued by the CDO entity have the highest potential rate of return, but in return have accepted the highest level of risk. Their return is divided into two parts with different priorities. The preferred dividend has a slightly higher priority than the participating dividend and return of investment. The preference shareholders have no obligations to provide additional funds to the CDO entity.
 - (e) Trustee and paying agents receive fees paid for the various services as a specified percentage of the market value of the CDO entity's investments (the debt instruments held, which serve as collateral for the holders of the securities issued by the arrangement). All of the fees are market-based.
 - (f) The swap counterparty provides an interest rate swap (pay fixed for variable) to support some of the variable-rate debt securities issued by the CDO entity.
7. In total, the reasonably possible cash inflows to the CDO entity depend on the specific debt instruments it holds. However, by design, there is a high probability that the collateral manager will receive its base fee, the providers of other services will receive their fees, and the holders of investment grade debt securities will receive all amounts contractually due. Payments to the various parties with interests in the CDO entity are made in the following order: the collateral manager's base fee and the other fees for the various services, interest and principal payments on the investment grade debt securities outstanding, the collateral manager's subordinate fee, interest and principal payments on the non-investment grade debt securities outstanding, preferred dividends on preference shares, the collateral manager's incentive fee, participating dividends on preference shares and return of investment on the preference shares. The preference shareholders' participating dividends are not fixed in amount; they represent the residual interest in the CDO entity after all other expenses are paid.

Case 2(a): Collateralized Debt Obligation – Scenario 1

8. The collateral manager holds none of the preference shares and the distribution of ownership of the preference shares is as follows:

Entity A	25 percent
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Entity B	25 percent
Entity C	25 percent
Entity D	25 percent

9. Multiple institutional investors hold the investment-grade and non-investment-grade debt securities issued by the CDO entity in various proportions.

Case 2(b): Collateralized Debt Obligation – Scenario 2

10. The collateral manager holds none of the preferred shares and the distribution of ownership of the preferred shares is as follows:

Entity A	50 percent
Entity B	20 percent
Entity C	20 percent
Entity D	10 percent

11. Multiple institutional investors hold the investment-grade and non-investment-grade debt securities issued by the CDO entity in various proportions.

Case 2(c): Collateralized Debt Obligation – Scenario 3

12. The percentages of ownership are the same as in Case 2(b), but Entity A (a holder of 50 percent of the preference shares) is also the collateral manager. Multiple institutional investors hold the investment-grade and non-investment-grade debt securities issued by the CDO entity in various proportions.

Case 3: Synthetic Lease Structure

13. A statutory trust is created to be the lessor ('Lessor') in a synthetic lease with a lessee ('Lessee'). Under the terms of the arrangement, the leased asset (the 'Facility'), an office building, will be constructed by Lessor at a cost of CU100 million and leased to Lessee for a lease term of five years. Upon expiration of the lease term, Lessee must choose one of the following options: (1) renew the lease upon terms mutually acceptable to Lessor and Lessee, (2) exercise a fixed price purchase option and acquire the Facility for CU100 million or (3) serve as Lessor's remarketing agent and sell the Facility to a third party for its then fair value. Lessee has provided Lessor a residual value guarantee in the event that Lessee chooses to remarket the Facility on Lessor's behalf. Under the terms of the residual value guarantee, Lessee will guarantee that the residual value of the Facility upon expiration or termination of the lease is CU100 million and will pay Lessor up to CU85 million if the Facility is not sold or is sold for an amount less than CU100 million. If the Facility is remarketed upon expiration of the lease, Lessee will receive sales proceeds in excess of CU100 million.
14. Lessor finances acquisition of the Facility by issuing a combination of debt and equity securities as follows:
 - Series A Notes in a principal amount of CU85 million,
 - Series B Notes in a principal amount of CU12 million, and
 - Equity Certificates with proceeds of CU3 million.
15. The Series A Notes are secured by an assignment of the Lessee's obligations under the residual value guarantee and a second lien on the Facility. The Series B Notes are secured by a first lien on the Facility. Rent paid by Lessee under the lease is equal to the debt service and equity yield payable on the Series A Notes, Series B Notes and Equity Certificates. The debt matures upon expiration of the lease and there is no principal amortisation of the debt during the lease term. All significant terms of the transaction are set forth in the operative documents. Holders of the Equity Certificates do not have the ability to make substantive decisions during the lease term. The operative documents require that the Equity Certificates be redeemed upon sale of the Facility. The debt indentures associated with the Series A Notes and Series B Notes restrict Lessor from incurring additional debt or entering into any transaction other than the lease. Entity A and Entity B each hold 50 percent of the Series B Notes and Equity Certificates. The Series A Notes are purchased by a commercial paper (CP)

conduit to which Entity A and Entity B provide a liquidity backstop. Under the liquidity backstop arrangement, should the conduit be unable to successfully sell its CP in the market, Entity A and Entity B will acquire the CP.

16. Lessee and Lessor have each classified the lease as an operating lease in accordance with IAS 17 *Leases*.

Case 4(a): Multi-Seller Conduit

17. A conduit engages in 10 transactions:
 - Eight transactions are with credit card operators. The transactions are for CU1 billion each. Due to the high spread between the rate of interest on each credit card account and the rate paid on conduit debt, only a 1 percent cash reserve is required to well secure the conduit. The total retained interest of these 8 credit card operators is CU80 million (CU10 million for each operator).
 - Large consumer credit corporation (LCCC) 1 transfers CU5 billion of prime consumer receivables in a two-step transaction to the conduit. LCCC's total retained interest equals 6 percent or CU300 million.
 - LCCC 2 transfers lease cash flows from CU2 billion of retail operating leases to the conduit. Residual values totalling 50 percent of the deal cannot be transferred to the conduit; they serve as over-collateralisation (or a 'retained interest') equal to CU1 billion.
18. The conduit is structured as a separate legal entity. Bank X funds the entity with CU10,000 of capital. For a nominal fee, an unrelated third party holds 100 percent of the entity's interests, which are designed to have little or no value at termination. The unrelated third party will maintain the conduit's books and perform other duties associated with maintaining the entity.
19. Bank X receives an administrator fee of 40 basis points per annum, a liquidity fee of 15 basis points per annum, and a credit enhancement fee of 5 basis points; all fees are comparable to fees in other similar arrangements. As administrator, Bank X evaluates and enters into asset purchases on behalf of the conduit. In exchange for the liquidity fee, Bank X stands ready to purchase the commercial paper (CP) in the event the conduit is unable to reissue it to another third party purchaser.
20. Additionally, Bank X provides a program-wide credit enhancement on 10 percent of the transferred assets, and, effectively, has full responsibility for the payment of all CP sold by the conduit in the event of default on any of the 10 transactions (due to a 'cease issuance' provision that requires the sponsor to buy back all CP, even if only one deal proves bad).
21. The CP totals CU13.62 billion (CU7.92 billion for the credit card deals, CU4.7 billion for the LCCC 1 deal and CU1 billion for the LCCC 2 deal), an

amount that is identical to the amount of the conduit's 10 loans. Since the 10 transactions are well secured (total collateral equals CU15 billion and the excess collateral for each transaction covers far more than the normal level of loan risk),

22. Bank X can demonstrate that its expected loss is no more than CU50 million. If one credit card deal proves fraudulent, however, the bank is responsible for 100 percent of the CU990 million of CP backing that transaction. No transferor other than the defrauding entity bears any liability for that loss; no transferor has any right to any other transferor's excess collateral.
23. Only Bank X has portfolio risk (all the normal risks of banking) and only the sponsor receives arbitrage profits of the conduit (the normal rewards of banking).
24. This table shows a summary of the above:

Transferor/ Borrower	Collateral of Transferor/ Borrower	Retained Interest	Liability to Conduit/ Asset of Conduit	Liabilities (CP) Issued by Conduit
Credit Card Operator 1 to 8	CU1 billion (each) (CU8 billion total)	CU10 million (each) (CU80 million total)	CU990 million (each) (CU7.92 billion total)	CU7.92 billion
LCCC 1	CU5 billion	CU300 million	CU4.7 billion	CU4.7 billion
LCCC 2	<u>CU2 billion</u>	<u>CU1 billion</u>	CU1 billion	<u>CU1 billion</u>
	CU15 billion	CU1.38 billion		CU13.62 billion

Case 4(b): Multi-Seller Conduit

25. Same facts as Case 4(a), except there are 40 additional transferors that transfer CU8 billion of collateral in total and keep retained interests of CU2 billion.