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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting:	**23 July 2008, London**
Project:	**Consolidation**
Subject:	**Illustrative case 1 (Agenda paper 14B(1))**

Case title

Structured Investment Vehicle

FACT PATTERN

Structured investment vehicle

1. A bank sponsor (Bank) sets up an offshore company, Structured Investment Vehicle (SIV), to invest in eligible securities based on strict investment policies. SIV gains return on a credit spread between investments in the asset portfolio and shorter term funding. The portfolio of CU100 million is composed primarily of investment grade asset-backed securities and financial institution debt, originated by third parties to SIV. SIV is a bankruptcy remote entity and has no other activities.

Investors

2. SIV raises funds continually by issuing securities with different maturity dates and credit risk. The investors have no obligation to provide additional funds to SIV. The classes of securities issued are following:

- **Commercial paper (CU83 million)**

  Commercial paper has a maturity date of 90 days after which they are rolled over. The holders of commercial paper are entitled to interest and principal payments before other investors. Because of lower risk exposure, they receive a lower rate of return than the holders of the medium-term and capital notes.

- **Medium-term notes (CU15 million)**

  Medium-term notes have a maturity date of 3 years after which they are rolled over. The holders of medium-term notes are entitled to interest and principal payments after the payments to the holders of commercial papers but before capital notes. Subordination of their interest provides credit enhancement to commercial papers holders. They bear a greater risk of loss than commercial papers holders and therefore receive a higher contractual rate of return.

- **Capital notes (CU2 million)**

  The capital notes are long-dated extendable notes with 10 years maturity date. The interest of capital note holders is subordinated to other investors and act as credit enhancement for more senior debt. Return on capital notes consists of two elements: a fixed base coupon that reflects the highest risk and a share of 45% in the SIV's residual profits. Capital notes are held by various investors (none has more then 10% of notes).

Bank

3. For setting up the structure, Bank receives a share of 5% in the SIV residual profits. Bank did not retain any involvement in SIV. It does not participate in the management of SIV, has no voting rights and obligation to provide financial support to SIV.

Directors

4. The directors oversee whether the parties to SIV adhere to the transaction documents. In specified circumstances, they have a right to replace the investment manager and administrator (and may consult Bank in selecting the replacement). They hold the ordinary shares of SIV that are nominal in amounts and without voting rights. The directors are independent to any party of SIV and receive a senior fee at market rates.

Investment manager

5. A hedge fund company (investment manager) is responsible for the dynamic management of the portfolio's credit and liquidity risk, selecting eligible assets that build up the portfolio, hedging interest rate and currency exposure, conducting asset valuations, and controls and reports various risk parameters on an ongoing basis.

6. The investment manager is managing the portfolio within various limits, tests and guidelines described in the operating manual. Due to the changing market conditions, the investment manager can modify provisions of an operating manual and some structural features subject to affirmation from a rating agency and the administrator. More fundamental changes require an approval of the majority of investors.

7. The investment manager receives a fee composed of two tranches: a senior fixed fee and a participating fee of 30% in the residual profits of SIV. Fees received are comparable with market practice. The investment manager holds 5% of capital notes.

Administrator

8. The administrator is responsible for managing the funding of the asset portfolio. It ensures that that SIV has continuous access to the debt capital market at the required level. Inability to roll or issue new commercial papers triggers a sale of the portfolio assets to pay off maturing debt. In addition, the administrator performs some middle and back office functions. For its services, it receives a senior market rates fees and a share of 20% in the residual profits of SIV.

9. The administrator provides a liquidity facility, renewable every year, that covers 10 per cent of debt obligations (CP and MTN). Liquidity facility may be drawn to cover temporary cash shortage to pay interests or repay principal payments to investors and is secured on non-defaulted assets of SIV (liquidity provider does not assume credit risk of the portfolio assets). The administrator receives a senior market based fee for its liquidity services.

Credit enhancement

10. SIV's profits are accumulated in a reserve account up to a specified amount and replenished regularly to retain a constant level of funds. The resources on the account are used to provide liquidity and credit support. The amounts collected above the required level in the reserve account (residual profits) are regularly distributed as a performance fee. Upon

liquidation of SIV, remaining funds in the reserve account, if any, are distributed to the parties entitled to receive residual profits in accordance with the participation share.

11. The subordinated capital notes and the reserve account are expected to cover in excess of SIV expected losses due to the high quality of portfolio assets. No additional credit enhancement is therefore provided. None of the parties to SIV has contractual obligations to provide further funds to support SIV's operations (other than described above).

Other parties

12. SIV transfers market risks by hedging cash flows on asset with independent swap counterparties. Other independent third parties are providing services to support operations of SIV eg accounts, a receiver, custodian, collateral agent. Fees paid to those parties are senior and at market rates.

Priority of payments

13. Payments to various parties with interests in SIV are made in a following order:

    1 fees to the swap counterparty and directors;

    2 fees to liquidity provider and the other fees for various services and agents;

    3 base fee to the investment manager and administrator's fee;

    4 interest and principal payments on commercial paper;

    5 interest and principal payments on medium-term notes;

    6 interest and principal payments on capital notes;

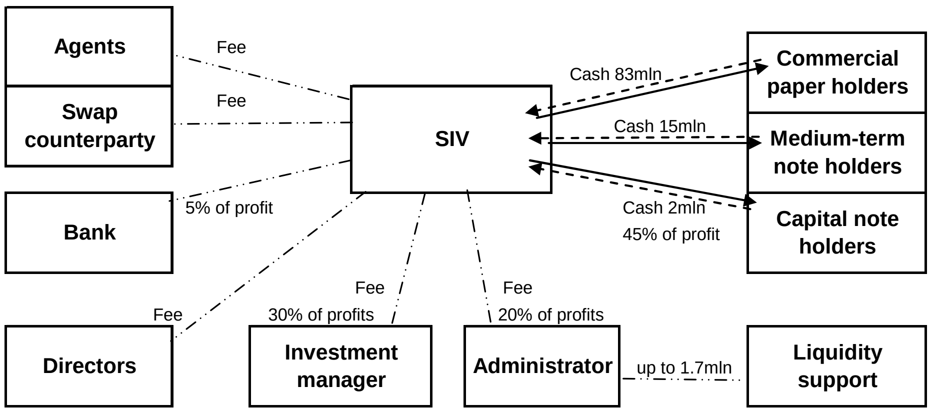
    7 distribution of the SIV residual profits.

Operating modes and enforcement

14. SIV can conduct its activities in a normal or restricted operating mode. In a normal operating mode, SIV has full investment and funding flexibility within the operating limits. Upon a breach of certain tests (eg capital, leverage, rating), SIV enters into restricted mode where SIV is managed in accordance with restricted investment and funding procedures until it can return to normal operations. A breach of more fundamental tests or the inability to restore failed tests within the allowed period of time results in an enforcement event. In such circumstances, a designated receiver would

replace the manager and liquidate the portfolio to redeem the debt with the aim of minimising losses of investors.

15. The flow of resources is summarised in the diagram that follows:



ANALYSIS IN ACCORDANCE WITH THE PROPOSED EDX

16. The purpose of SIV is to carry out investment activities. The power over the strategic financing and operating policies available to investors is limited and their ability to access the assets of SIV is restricted. That is investors' decision-making rights would be exercised to protect their interest rather than to affect the performance of SIV. The party that obtains and is exposed to changes in benefits of SIV and that can take decisions affecting performance of SIV would control and consolidate SIV.

Sponsor

17. Bank, in a role of a sponsor, structured and determined features and policies of SIV. However, it is not able to affect the way the assets and liabilities are subsequently managed and profits generated. Bank does not participate in decision making and cannot change policies governing operations of SIV. To be involved in the operations of SIV, Bank would have to obtain agreement from, and negotiate terms with, investors and other parties of SIV.

18. Bank is not obliged to provide any support to SIV. It participates in the distribution of residual profits of SIV, however, Bank receives return commensurate with the service provided. Its fees vary with the SIV performance in order to remunerate Bank for structuring SIV such that continuity of SIV operations and profitability is achieved. Bank provides services to SIV as an agent and does not control SIV.

Investment manager

19. The investment manager has discretion in managing the activities of SIV and affects generated profits. However, it does not have sufficient power to control all decisions affecting operations of SIV. This is because administrator manages the financing side of SIV and the ongoing changes to the investment and financing policies have to be approved by administrator.

20. The investment manager is exposed to changes in SIV benefits, because it is entitled to a share of SIV residual profits. It receives fees that correspond with the service provided and that vary with the performance of SIV to encourage the investment manager to maximise results. It is also exposed to risks through 5% interest in capital notes. The size of the interest is insignificant and held to increase investors' confidence in the investment manager skills. The investment manager does not control SIV.

Administrator (liquidity provider)

21. The administrator manages the financing side of SIV and provides financial support essential for continuity of operations of SIV. To protect its interest, it can veto the investment manager's decisions on changes to investing and financing policies. It cannot however direct the investment activities of SIV that are managed by the investment manager. It receives a share of SIV benefits, but its fees reflect market practice and services rendered as an agent. The administrator does not control SIV.

Agents and swap counterparty

22. The agents and swap counterparty provide services in exchange for a senior market-based fee. The parties can be replaced and shall follow the instruction of the investment manager and administrator. They do not have decision making power sufficient to control SIV and obtain benefits of SIV.

Directors

23. The directors act in a fiduciary capacity for investors and do not control SIV. They oversee compliance with the legal and contractual requirements of the parties to SIV. They can replace the investment manager and administrator, but only in the specified events. The directors receive a senior and fixed fee at market rates. The rights they have are not sufficient to affect and receive benefits of SIV.

Conclusion

24. The activities of SIV are directed by the investment manager and administrator, therefore, none of the parties alone have sufficient power to take all decisions that affect the performance of SIV. The rights of other parties to SIV to govern the strategic financing and operating policies are restricted. In addition the benefits generated by SIV are distributed to various parties in accordance with the risk assumed and services provided. None of the party to SIV control and should consolidate SIV.

Variation 1: Sponsor receives significant profit share (eg above 20%)

25. The sponsor of SIV without other involvement in SIV activities may receive a high share of profits. The reasons for the sponsor receiving high profits for structuring SIV, can be due to a high profile of the product. In addition, the fees and interests paid to other parties may be determined at high level, such that the residual profits would not be significant in absolute amounts.

26. However, if the sponsor receives excessive remuneration in comparison to other parties, it seems that this would occur only if it provides other services. The importance of those services and resulting rights and obligations should indicate whether the sponsor controls SIV (eg ability to appoint and remove or direct decisions of managing parties).

Variation 2: Sponsor participates in managing SIV activities

27. The sponsor may provide some supporting services relating to operations of SIV. The sponsor would act as an agent provided that in exchange it receives fixed fees at market rates and is not able to effectively direct investing and financing activities of SIV.

Variation 3: Investment manager and administrator is the same party

28. The responsibilities of investment manager and administrator can be held by the same party (manager). In this case, the manager would be able to take all investing and financing decisions affecting SIV performance whereas the power of other parties to SIV to direct the policies of SIV is restricted. The manager would be also entitled to receive half of the benefits of SIV and be exposed to variability in benefits through the liquidity facility it provides. The manager would therefore control and consolidate SIV.

29. The power of manager can be constrained by the rights held by the other parties. If the rights are provided to protect the interest of investors and other parties to SIV rather than enable them participation in directing SIV, they should not negate control of the manager. The following rights would represent protective rights:

- Constraints on the manager's investing and financing activities by various tests and limits established at the inception of SIV.
- The requirement that changes to investment policies should be approved by the rating agency and fundamental changes—by investors. The veto rights are provided to ensure that the proposed changes do not result in a loss to, or unfavourable treatment of, investors and other parties.
- The directors' right to replace the manager in the specified circumstances where the right is provided to prevent manager's negligence of due care.

ANALYSIS IN ACCORDANCE WITH CURRENT GAAPs

[Paragraphs 30-36 omitted from observer note.]