

**International
Accounting Standards
Board**

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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: 23 July 2008, London

Project: Consolidation

Subject: Illustrative case 3 (Agenda paper 14B(3))

Case title

Multi-Seller Conduit

FACT PATTERN

Conduit

1. Bank structured a multi-seller conduit as a separate legal entity. The conduit's activity is to invest in loans originated by third parties on an ongoing basis from funds obtained by issuing commercial paper. The aim of the conduit is to provide alternative financing to the transferors of the assets and generate benefits from the term structure of credit spreads.
2. The conduit issued commercial paper (CP) at par value of CU15.6 billion to fund the transfer of the receivables to the conduit. The CP has a short-term maturity date after which it is rolled over. None of CP is linked to specific assets of the conduit.

Transactions

3. Twelve parties transferred receivables to the conduit:

- **Credit card operators (CU10 billion)**

Ten credit card operators transferred credit card receivables of CU1 billion each to the conduit (ie CU10 billion in total). Due to the high excess spread between the rate of interest on each credit card account and the rate paid on CP, only one per cent cash reserve is required to secure losses on the receivables. The total retained interest of these ten credit card operators is CU100 million (CU10 million for each operator).

- **Retailer (CU5 billion)**

A retailer transferred CU5 billion of prime consumer receivables to the conduit. The retail bank total retained interest that serves as over-collateral equals six per cent (ie CU300 million).

- **Leasing company (CU1.7 billion)**

A leasing company transferred lease cash flows of CU1.7 billion of retail operating leases to the conduit. The leasing company's total retained interest that serves as over-collateral equals CU700 million.

4. The conduit has a revolving assets structure, ie principal collections on the conduit's receivables are used to purchase new eligible receivables and replenish the conduit's portfolio rather than repay CP. The transferors (originators of the assets) continue to service the assets transferred to the conduit.
5. The assets transferred to the conduit are not cross-collateralised with other assets of the conduit. Therefore, no transferor bears any liability for loss on other transferor's assets; no transferor has any right to any other transferor's excess collateral. All transactions are well secured; the total collateral equals CU16.7 billion and over-collateral for each transaction covers more than the expected losses on the transferred assets.

Bank

6. Bank provides administration, liquidity and credit enhancement services for which it receives fees comparable to market fees in other similar arrangements and senior to principal payments on CP. Bank does not own any equity or debt interest in the conduit.
7. Bank in the role of an administrator has the following responsibilities related to the management of the conduit's operations:

- Manage daily operations of the conduit (establish the programme, arrange for the execution of the program documents, prepare monthly portfolio reports, maintain operating accounts and accounting records, prepare financial statements, invest free funds in eligible investments);
 - Issue, manage and repay the CP (determine features of the CP issued, instruct agents, determining when draws on liquidity and credit enhancement facilities are necessary);
 - Evaluates and enters into asset purchases and hedging arrangements (identify, conduct due diligence reviews and approve new transferors, approve the assets transferred, structure the acquisition of asset interests and any necessary hedging arrangements, monitor the ongoing performance of each transaction).
8. As the liquidity facility provider, Bank stands ready to provide funds to the conduit to fund the purchase of all CP in the event the conduit is unable to reissue them to other third party purchasers (for reasons other than credit deterioration of the portfolio assets).
 9. Bank also provides credit enhancement in form of a guarantee on 10 per cent of the transferred assets that should absorb all expected losses of the conduit. Bank absorbs the conduit's losses up to the guaranteed amount after the losses exceed the over-collateral provided by the defaulted transferor. Any losses in excess of the guarantee would be absorbed by all CP holders proportionally to their interest.
 10. The excess spread, that represents net interest payments on the conduit's receivables after paying all expenses and payables, is deposited to a reserve account. The account is used to cover credit default on the portfolio receivables. The amounts accumulated on the reserve account above specified level are regularly distributed to Bank. Upon liquidation of the conduit, any residual amounts are paid to Bank.

Policies

11. The conduits activities are governed by formal credit and investment policies established at the inception of the structure. The policies provide the administrator and other agents with guidelines for investment eligibility, transaction structure and portfolio composition. The guidelines specify among others minimum transferors credit quality and asset eligibility, transaction size limits, required credit enhancement, hedging and structural elements in asset transfer transactions. Under specified circumstances, Bank may amend the provisions of the policies subject to the approval of a rating agency.

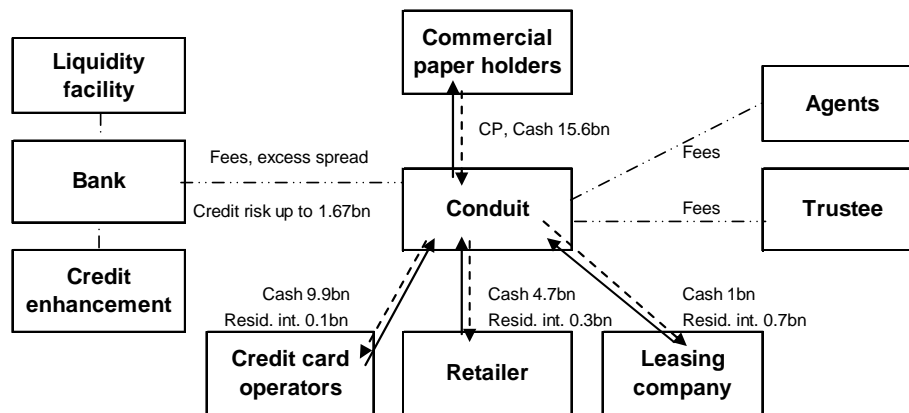
Other parties

12. An unrelated third party, a trustee, holds the conduit's nominal equity that has no voting rights. The trustee ensures that parties comply with all requirements, including the payment priority schedule, and performs tasks to maintain the conduit's independent corporate existence. It also has rights to replace the administrator on occurrence of events specified in the transaction documents. For its services, the trustee receives a nominal senior fee.
13. Independent third party agents provide supporting and administrative services to the conduit (for example, settlement of issued and repaid CP, maintenance of the conduit's account, coordination of CP sale, enforcement of the conduit's rights). The conduit may enter into agreements with hedge counterparties. The agents receive a senior market based fee for their services and must adhere to the policies specified in the transaction documents and Bank's instructions.

Termination events

14. The conduits will stop issuing commercial paper and acquiring further assets on occurrence of the events specified in the transaction documentation. In such circumstances, the trustee would appoint a designated third party agent that would liquidate the loan portfolio on the market and pay down the CP holders. Any losses would be absorbed in the order outlined in paragraph 9. The conduit will terminate its activities, for example, on the conduit's rating downgrade below a certain level, breach of the conduit's policies and key test, default of the administrator or unavailability of credit enhancement or liquidity facility for a specified period of time.
15. A default or bankruptcy of the transferor would not result in liquidation of the conduit, provided that termination events or breach of key tests did not occur. The administrator would limit an issue of CP and provide any required liquidity facility to continue the conduit's activities. It has rights to work out the transferor default and refer a new transferor to the conduit.

16. The flow of resources is summarised in the diagram:



ANALYSIS IN ACCORDANCE WITH THE PROPOSED EDX

17. The conduit is structured to provide financing to the transferors of receivables, investment opportunity for the CP holders and arbitrage opportunities for the administrator. In order to determine whether any party controls the conduit, the activities of the conduit and effectively its assets and liabilities should be identified. The party that can direct, and benefits from, the financing and investing policies of the conduit should consolidate and recognise the assets and liabilities of the conduit.

Determining the assets and liabilities of the conduit

18. The transferors retain servicing and absorb the expected losses on their receivables. They have rights to manage the defaults and replace the maturing assets with new eligible receivables. The transferors of credit card receivables retained rights to manage the borrowers' account and terms of the loans. The conduit does not have rights to the receivables other than as a security for the loan (its access to use or manage the assets is restricted unless transferor defaults). The transferors should continue to recognise the receivables and recognise cash received as a loan from the conduit.
19. The conduit should therefore recognise the loans to the transferors rather than the transferred receivables and the liability toward CP holders. The conduit should reflect the economic substance of the arrangement which is *lending* activity— borrowing funds from the CP holders and lending funds, secured on the transferred receivables, to the transferors.

Determining control over the conduit

Transferors

20. The transferors retained control over the receivables transferred to the conduit, but none of them controls the conduit. They cannot direct the conduit's activities and benefit from the profits it generated. They should continue to recognise the receivables, loans from the conduit up to the amount of cash received and the retained interest that serves as credit enhancement.

Agents

21. The agents provide services in exchange for a market-based fee that is senior and fixed. The parties can be replaced and shall follow the instruction of the administrator. They do not have decision making power that would enable them control of the conduit and do not absorb variability of the conduit's activities.

Trustee

22. The trustee acts in a fiduciary capacity for the CP holders. It oversees compliance of the conduit and administrator's activities with the legal and contractual requirements. In return it receives a senior fixed fee at market rates. Trustee has the right to replace the administrator, but only in the event described in the transaction documents. It does not have discretion how the activities of conduit should be managed.

Bank

23. Bank manages the financing and lending activities of the conduit that determine the level of the profits generated by the conduit. The established policies followed by Bank limit Bank's power in order to protect the interest of CP holders. Rights held by CP holders are limited such that they cannot direct activities of the conduit and affect the benefits generated by it.
24. It seems that Bank is the main beneficiary of the conduit's activities that it directs. It receives all profits generated by the conduit, after setting liabilities to the agents and CP holders. It also provides financial support (ie liquidity and credit enhancement facilities) to the extent required to carry ongoing activities of the conduit and that exposes Bank to losses, although to limited amounts. This support would affect tests and limits, which, if not met, may lead to replacement of administrator or liquidation of the conduit. Bank therefore has sufficient power to minimise occurrence of those events. Bank therefore controls and should consolidate the conduit.

Conclusion

25. Transferors of the receivables to the conduit retain control over their assets. They retain servicing of the receivables and are exposed to variability of those assets. The conduit should recognise the loans given to the transferors secured on the receivables and liability toward CP holders.
26. The power to direct strategic financing and operating policies of the conduit available to CP holders is restricted. Bank in a role of administrator has sufficient decision making rights to affect benefits generated by the conduit. It is also exposed to variability of the conduit's performance through the financial support it provides. The aggregate roles of Bank result that it is entitled to receive all residual profits of the conduit. Bank should therefore consolidate the conduit's assets (loans to the transferors) and liabilities (CP).

Variation: Lower than expected returns of the conduit losses absorbed by an external party

27. It is assumed that the majority of any lower than expected returns of the conduit are absorbed by an independent insurer in exchange for a market based fee (ie 'expected loss note' holder). Bank would continue to manage all key activities of the conduit (investment and financing decisions), assume risk on liquidity disruptions and insignificant credit risk after the insurer, and receive conduit's residual profits (after deducting fees to CP holders, agents and the insurer). Bank controls and should consolidate the conduit, because it would take decisions affecting the conduit's benefits and is exposed to variability in conduit's performance.

ANALYSIS IN ACCORDANCE WITH CURRENT GAAPs

[Paragraphs 28-36 omitted from observer note.]