

# Memo

Barclays Capital

To SCM Approvals Committee

From Adam Moses

Date [ ] October 2007

Subject Pre-approvals paper – Project Faber

# BARCLAYS

## 1. SUMMARY

Structured Capital Markets (“SCM”) is seeking approval for Project Faber (the “Transaction”) with the Luxembourg branch (“LuxBank”) of HSH Nordbank AG (“HSH”). LuxBank will be a Luxembourg resident financial institution. The Transaction involves Barclays Investment Bonds (Isle of Man) Limited (“BIB (IoM)”) investing through a Luxembourg resident company (“LuxCo”) in a portfolio of high grade investments. BIB (IoM) will forward sell preference shares issued by LuxCo (the “B Prefs”) to LuxBank.

### Economic Benefit

Due to the availability of certain Luxembourg tax benefits, LuxBank is able to provide a gross up under the Forward for any Luxembourg withholding tax suffered on the B Prefs. To the extent that withholding tax arises, BIB (IoM) will be able to take this into account in computing its chargeable profits for CFC purposes with the effect that no apportionment will be required for the relevant accounting periods covering the transaction. LuxBank will derive a benefit of £[2.1]m from the Transaction.

The key financial data is set out below:

	Pre provision (if any)	Post provision (if any)
Proposed size of transaction	£[1,496.1]m, stepping down to £[1,123.8]m after approx. 30 days.	N/A
Estimated revenue	£[9.6]m in 2007, £[11.9]m in 2008, £[7.8]m in 2009.	£[2.9]m in 2007, £[(0.7)]m in 2008, nil in 2009.
Tax capacity Return on Tax capacity	£[24.1]m in 2007, £[73.4]m in 2008, £[27.1]m in 2009. [23.5]% for transaction	£[24.1]m in 2007, £[73.4]m in 2008, £[27.1]m in 2009. [1.8]% for transaction
WRAs Return on WRAs	£[10.5]m [278.5]% for transaction	£[10.5]m [21.5]% for transaction
PUG	N/A	£[(51.1)]m in 2007, £[8.2]m in 2008, nil in 2009.
Tenor	[364] days	N/A

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This Approvals paper contains a description of all significant tax, credit, market and operational risks.

## 2. DETAILED TRANSACTION DESCRIPTION

The paragraphs below provide a summary of the Transactions steps. A detailed transaction description is attached at Appendix 1.

### Transaction Steps

- 2.1 BIB (IoM), a wholly owned, Isle of Man resident subsidiary of Barclays currently has a deposit with Barclays of £[915.6]m.
- 2.2 [5] days before the closing date, via BIB (IoM)'s immediate parent Murray House Investment Management Limited ("MHIML"), Barclays will capitalise BIB (IoM) with £[207.9]m of ordinary shares.
- 2.3 BIB (IoM) will then use the £[207.9]m proceeds and £[914.6]m of its existing deposit to set up a UK limited partnership ("LP") with another wholly owned subsidiary of Barclays ("UKSub") and acquire the "LP Interest". UKSub will acquire the "GP Interest" for £[1]m.
- 2.4 LP will invest the £[1,123.5]m cash in a portfolio of short term reverse repos over OECD sovereign securities.
- 2.5 Prior to closing, BIB (IoM) will change its current accounting period end date to [15 May 2007] and adopt IFRS in respect of the new accounting period.
- 2.6 On the closing date, BIB (IoM) and LuxBank will set up a Luxembourg incorporated and resident S.a.r.l. ("LuxCo").
- 2.7 LuxBank will acquire the "A Shares" for £[100]k which will carry 99% of the votes in LuxCo.
- 2.8 BIB (IoM) will transfer the LP Interest to LuxCo in exchange for the £[1,122.5]m "B Prefs" in LuxCo. The terms of the B Prefs are such that they are mandatorily redeemable after [364] days and redeemable at the option of LuxCo. In addition, the redemption price of the B Prefs is as follows: Par + LIBID – gross dividends declared.
- 2.9 BIB (IoM) will also enter into a forward (the "Forward") over the B Prefs with LuxBank for delivery in [364] days time. The Forward may be accelerated by either party on notice. The price payable under the Forward (the "Forward Price") will be Par + LIBID – net dividends declared. The difference between the redemption price of the B Prefs and the Forward Price is equal to any Luxembourg withholding tax levied on the B Prefs dividends.
- 2.10 HSH will enter into a credit derivative contract (the "CDS") with Barclays under which Barclays will compensate HSH to the extent that the redemption value of the B Prefs is less than their initial par value less any gross dividends declared.
- 2.11 HSH and BIB (IoM) will enter into an Assignment Agreement (the "Assignment Agreement") under which HSH will transfer any amounts falling due under the CDS to BIB (IoM) as part settlement of HSH's obligations to pay the Forward Price under the Forward.
- 2.12 BIB (IoM) will use the remaining £[1]m of its existing deposit with Barclays to subscribe for the "C Shares". The C Shares are redeemable at the option of either LuxCo or BIB (IoM).
- 2.13 LuxCo will invest the proceeds of issuing the A Shares and the C Shares in a portfolio of reverse repos over OECD sovereign securities.

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2.14 Also on closing, via MHIML, Barclays will capitalise BIB (IoM) with an additional £[48.2]m of ordinary shares.

2.15 BIB (IoM) will then make use of a drawdown facility provided by Barclays to borrow £[297.5]m, which it will combine with the £[48.2]m capitalisation proceeds to make a capital contribution of £[345.7]m to LP.

2.16 [15] days after the capitalisation of LuxCo, LP will declare a dividend to LuxCo and LuxCo will correspondingly declare a dividend on the B Prefs. In both cases the dividends will be declared for payment [14] days later.

2.17 [29] days after the capitalisation of LuxCo, LP will liquidate part of the LP Portfolio in order to pay LuxCo the dividend declared. LuxCo will use the proceeds to pay a net dividend on the B Prefs, after deduction of 15% Luxembourg WHT.

2.18 It is anticipated that the dividend on the B Prefs will be declared prior to 31 December 2007 and but will be paid after the year end during the first week of January 2008. However, it is possible that both declaration and payment of the dividend will occur in January 2008.

#### **Early unwind/Maturity**

2.19 It is anticipated that LuxBank will initiate the liquidation of LuxCo using its rights under the A Shares.

2.20 LP and the LP Portfolio will be liquidated, each of UKSub and LuxCo receiving their original capital contributions plus any remaining pro rata share of LP's profits.

2.21 The Forward will be automatically accelerated and cash settled.

2.22 The B Prefs will be redeemed for their redemption value and the proceeds used to settle the Forward.

2.23 The A Shares and the C Shares will receive their relevant liquidation entitlements.

2.24 In the event that LuxBank does not initiate the liquidation of LuxCo, BIB (IoM) will exercise its rights to redeem the C Shares and accelerate the Forward.

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### 3. ECONOMICS AND ECONOMIC DRIVERS

3.1 The economic benefit of the transaction is computed as follows:

3.1.1

BIB (IoM) solus	Transaction Total £m
Deposit interest	52.5
MTM profit on financing (B Prefs)	52.5
Interest on Barclays Loan	(1.5)
Dividend on C Shares	-
Return on C Shares	14.7
PBT	<u>118.2</u>
Tax	-
PAT	<u>118.2</u>

3.1.2

BBPLC Solus	Transaction Total £m
Assumed funding cost of transaction	(74.0)
Assumed funding cost of deposit	(52.5)
Interest on Barclays Loan	1.5
Dividend from UKSub	0.3
PBT	<u>(124.7)</u>
Tax	35.7
PAT	<u>(89.0)</u>

3.1.3 Profit after tax for the Barclays Group (i.e. BIB (IoM)'s economic profit of £[118.2]m which is not taxable in the Isle of Man and Barclays post tax position (including assumed funding costs) of £[(89.0)]m is £[29.2]m pre-provision. This is equivalent to Barclays pre-provision revenue from the transaction of £[40.9]m on a pre-tax equivalent basis.

3.1.4 The reverse repos over OECD sovereign securities in the LP and LuxCo Portfolios are expected to pay a return of LIBOR less [40] bps. The collateral costs will be borne by Barclays and are £[4.6]m. This cost is already included in the benefit calculation above.

### 4. TAX ANALYSIS/CONSEQUENCES

#### 4.1 UK Tax Consequences

4.2 The key points of the following UK tax summary have been discussed with Freshfields and are supported by the tax note attached at Appendix [2]. Prior to submission of this paper to the Approvals Committee, an opinion will be obtained which fully covers the points outlined in the note.

4.3 Barclays and UKSub are UK tax resident. BIB (IoM) is tax resident in the Isle of Man and LuxCo should be Luxembourg tax resident.

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**BIB (IoM) solus (£m)**

Deposit interest  
MTM profit on financing (B Prefs)  
Interest on Barclays Loan  
Dividend on C Shares  
Return on C Shares

PBT

Tax

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**BBPLC Solus (£m)**

Assumed funding cost of transaction  
Assumed funding cost of deposit  
Interest on Barclays Loan  
Dividend from UKSub  
PBT

Tax

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4.4 **Barclays**

- 4.4.1 Interest receivable on the Barclays A Facility should be taxable.
- 4.4.2 Interest payable on the Barclays Deposit will be deductible.

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4.5 **BIB (IoM)**

4.5.1 In computing the chargeable profits of BIB (IoM) for CFC purposes, the following tax consequences should arise from the Transaction:

- 4.5.1.1 The B Prefs, but not the C Shares, should fall within the provisions of s.91B FA 1996, therefore BIB (IoM) chargeable profits should include its LIBID return under the B Prefs.
- 4.5.1.2 £[52.5]m of the £[52.5]m Luxembourg WHT suffered on the B Prefs should be deductible under s.811 ICTA 1988.
- 4.5.1.3 It has been assumed that interest payable on the Barclays A Facility will not be deductible.
- 4.5.1.4 The proportion of Luxembourg WHT applicable to the accounting period in which the B Prefs dividend is paid should be "creditable tax" as defined by s.751(6)(a) and should reduce BIB (IoM)'s chargeable profits accordingly.
- 4.5.1.5 Any return on the C Shares should be treated as capital therefore excluded from the chargeable profits calculation.
- 4.5.1.6 BIB (IoM)'s pro rata share of the profits of LP for the pre closing period during which it holds the LP Interest should be taxable.

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	Transaction Total £m
<b>BIB (IoM) CFC comp (total)</b>	
Deposit interest	52.5
91D income	52.5
Section 811 deduction for WHT	(52.5)
Capital gain on C Shares	14.7
Interest on Barclays Loan	(1.5)
C shares dividend	-
Gross chargeable profits	<u>52.5</u>
Creditable tax	(52.5)
Net chargeable profits	<u>(0.0)</u>

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4.5.2 BIB (IoM) should not be a CFC for the 12 month accounting periods ended [15 May 2008] and [9 May 2009]. [The BIB (IoM) accounting period for 2008-2009 is changed to end 9 May 2009.]

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<b>BIB (IoM) CFC comp (total)</b>
Deposit interest
91D income
Section 811 deduction for WHT
Capital gain on C Shares
Interest on Barclays Loan
C shares dividend
Gross chargeable profits
Creditable tax
Net chargeable profits

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4.6 **LuxCo**

4.6.1 LuxCo should not be UK controlled for the purposes of s.765 ICTA 1988 or the Controlled Foreign Company rules as LuxBank has [99]% of the votes.

4.7 **UKSub**

4.7.1 UKSub should be taxable on its pro rata share of the profits of LP based on its allocation under the partnership agreement.

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4.8 **LP**

4.8.1 LP should be a disregarded entity for the purposes of UK tax. Its profits should be taxable on its partners in accordance with the profit sharing

arrangements,

#### 4.9 UK Disclosure Rules

4.9.1 The Transaction will be disclosed to HMRC.

#### 4.10 Luxembourg Tax Consequences

4.10.1 The key points of the following Luxembourg tax summary have been discussed with Bonn Schmitt Steichen ("BSS") and are supported by the tax opinions attached at Appendix [3]. The tax analysis will be confirmed in advance with the Luxembourg authorities by way of a ruling.

#### 4.11 LuxCo

4.11.1 LuxCo should not be taxable on the distributions received from LP because this will be considered income derived from an exempt participation.

4.11.2 LuxCo will be subject to tax on the interest income from the LuxCo Portfolio.

4.11.3 Capital duty should not be payable on the issuance of the B Prefs in exchange for the LP Interest nor on the capital contribution made by BIB (IoM) to LP. The former is an exempt share-for-share exchange whilst the latter is a non-taxable indirect capital contribution. However, capital duty at 1% will be chargeable on the issuance of the £[100]k A Shares and the £[1]m C Shares.

4.11.4 LuxCo will be obliged to withhold tax at a rate of 15% on dividends paid under the A Shares to LuxBank and under the B Prefs to BIB (IoM) (anticipated to be £[315]k and £[52.5]m respectively).

4.11.5 An immaterial amount of net wealth tax will be payable as LuxCo's holding in LP is an exempt asset.

#### 4.12 LuxBank Tax Analysis

4.12.1 LuxBank should be treated as beneficial owner of the B Prefs [and is taxable on [50]% of any dividends paid on the B Prefs.]

4.12.2 LuxBank should receive a deduction equal to [50]% of the fall in value of the B Prefs which occurs when the B Prefs dividend is paid. This should offset the taxable dividend income in [4.12.1]

4.12.3 LuxBank should also be entitled to claim a credit against its corporate income tax liability for the 15% WHT applied to the B Prefs dividend.

4.12.4 Dividends receivable under the A Shares should be [50]% taxable. However a credit should be available for the 15% Luxembourg WHT suffered.

### 5. TAX RISK

5.1 Based on discussions with Freshfields, the key tax risks in the Transaction are summarised below. A full discussion of the risks is included in the tax note from Freshfields in Appendix [2].

#### 5.2 UK Tax Risk

##### Section 91B Risk on B Prefs

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5.2.1 The B Prefs should fall within section 91B FA 1996 (“Section 91B”) since for these purposes BIB (IoM) should be treated as holding the B Prefs (irrespective of the Forward) and the B Prefs should satisfy the conditions in s.91D FA 1996:

5.2.1.1 The B Prefs are redeemable within the meaning of section 91D(2);

5.2.1.2 Given the formula for the B Prefs redemption price, the B Prefs are designed to give a LIBID return (which equates to the return one would expect on an investment at a commercial rate of interest); and

5.2.1.3 There are strong arguments that BIB (IoM)’s purpose in holding the B Prefs is to secure a “tax advantage”.

5.2.2 There is a risk that the B Prefs do not in fact satisfy condition 2 of s.91D and hence do not fall within s.91B. The B Prefs redemption formula is by reference to gross dividends whereas BIB (IoM) suffers 15% WHT on any dividend received under the B Prefs. Although this is adjusted for by the pricing under the Forward (and indeed, the solus accounts of BIB (IoM) will show a net LIBID return on BIB (IoM)’s investment), looking at the B Prefs in isolation, it could be argued that they do not give a LIBID return. However, if the B Prefs did fail to satisfy condition 2, then they should satisfy the conditions in s.91E by virtue of the Forward and hence still fall within the provisions of s.91B.

5.2.3 The effect of failing to fall within s.91B would be that, instead of being taxed on a fair value basis (i.e. on the net LIBID interest earned on the “in substance” loan to LuxBank), the B Prefs would generate £[350.0]m taxable income in respect of the B Prefs dividend plus a £[300.5]m loss on redemption which could be disallowed. However the risk that neither s.91D nor s.91E applies is considered remote.

#### Section 91B Risk on C Shares

5.2.4 There a risk that the C Shares fall within s.91B such that any return on the C Shares is taxed as income. The C Shares are entitled to the residual net assets of LuxCo after return of capital and dividends on the A Shares and the B Prefs. However, given the costs which are borne by LuxCo (including LuxBank’s fee under the A Shares), the return on the C Shares will be significantly lower than LIBID and so the conditions in s.91A-s.91E should not be met.

5.2.5 With regard to case law in respect of whether the return is income or capital, and on the basis that BIB (IoM) should neither be held to be trading nor, as discussed above, fall within the loan relationship provisions, the £[14.7]m return on the C Shares should be treated as capital and therefore excluded for the purposes of BIB (IoM)’s chargeable profits calculation.

5.2.6 In the event the C Shares are in fact treated as income for the purposes of CFC tax, s.42 FA 1998 provides that income should be computed in accordance with generally accepted accounting practice. Since the accounts of BIB (IoM) will show only the profit over and above the C Share subscription and the capital contribution, income for these purposes would be £[14.7]m.

#### Para 13 Risk

5.2.7 The risk that paragraph 13, Sch 9 FA 1996 (“Para 13”) applies to interest payable on the Barclays deposit is not considered to be material on the basis that such interest would be payable irrespective of whether the Transaction took place or not.

5.2.8 Since Barclays will use non-interest bearing current accounts (“NIBCAs”) to fund repayment of BIB (IoM)’s deposit, it will not be possible to identify any interest debits in respect of this funding. Therefore it should not be possible to apply Para 13 to such funding.

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5.2.9 The Barclays A Facility will only be in place for [29] days. Under Para 13, interest payable of £[1.5]m may be disallowed in BIB (IoM)'s chargeable profits calculation and has been assumed non deductible for the purpose of calculating the benefit of the Transaction.

#### Section 811 Risk

5.2.10 In cash terms, BIB (IoM) will suffer WHT and receive a net dividend on the B Prefs. Therefore BIB (IoM) will claim a s.811 ICTA 1988 ("Section 811") deduction in respect of this Luxembourg WHT. There is a risk that the deduction is disallowed on the basis that when the Forward is taken into account, BIB (IoM) has no net exposure to the WHT. However, the receipt of a payment under the Forward should arguably not impact on an analysis of the amount of tax "paid" for s.811 purposes.

5.2.11 It is also helpful that LuxBank is anticipated to be in a net tax paying position and will therefore claim a credit in respect of the WHT rather than a refund. This reduces the risk of an adjustment under s.811(4).

5.2.12 In the event that the s.811 deduction is disallowed, BIB (IoM)'s chargeable profits for the relevant accounting period will be increased. BIB (IoM) is likely to be classified as a CFC for the period and will be required to pursue an acceptable distribution policy ("ADP") and pay 90% of its chargeable profits to MHIML as a dividend which will be taxable in the hands of MHIML (assuming the time limit for an ADP has not expired) or suffer an apportionment of its chargeable profits to MHIML, the apportionment also being taxable on MHIML.

#### Section 751(6) Risk

5.2.13 There is a risk that for the purpose of calculating its chargeable profits, BIB (IoM) cannot include a proportion of the Luxembourg WHT suffered on the B Prefs as "creditable tax" under s.751(6) ICTA 1988 ("Section 751(6)").

5.2.14 Assuming that s.804ZA ICTA 1988 applies, BIB (IoM) should be assumed or deemed to have made a s.805 ICTA 1988 election and therefore eligible to claim a deduction for the Luxembourg WHT suffered on the B Prefs as described above.

5.2.15 In addition, s.751(6) provides that "creditable tax" for CFC purposes includes the amount of any relief from corporation tax which would be given to BIB (IoM) in respect of any foreign tax which is brought into account in determining those chargeable profits. Therefore BIB (IoM) will also claim a capped amount of Luxembourg WHT as creditable tax (i.e. the amount of the WHT which is attributable to the B Prefs income included in BIB (IoM)'s chargeable profits calculation for the period in which the B Prefs dividend is paid). Unlike the s.811 deduction, creditable tax for CFC tax purposes can be set off against existing income in BIB (IoM), further reducing its chargeable profits.

5.2.16 **Potentially expand tax risk section subject to risks identified in revised Freshfields Note.**

## 6. ACCOUNTING

6.1 Barclays, BIB (IoM), UKSub and LP will prepare their solus financial statements under IFRS in sterling. LuxCo will prepare its accounts under Lux GAAP in sterling. Barclays and LuxBank both prepare consolidated financial statements under IFRS in sterling and Euros respectively.

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6.2 The consolidated accounting analysis is summarised below. A detailed accounting analysis, including the solus accounting in respect of each entity, is attached at Appendix [4].

6.3 The accounting treatment has been agreed with SCM Finance and with PwC.

6.4 **Barclays consolidation analysis**

6.4.1 Barclays owns 100% of the share capital and voting rights in BIB (IoM) and UKSub and will therefore continue to consolidate both BIB (IoM) and UKSub under IAS 27.

6.4.2 As GP, UKSub (and therefore Barclays) will control LP and will make all the management decisions in respect of LP and the LP Portfolio. Therefore Barclays will consolidate LP under IAS 27.

6.4.3 LuxCo is an SPE under SIC-12 since, although LuxBank will own [99]% of the voting rights, LuxCo, which will have restricted articles of association, will be created for a specific, well defined purpose and its activities will be restricted. Barclays will receive the majority of the reward from LuxCo's activities and is exposed to the majority of risks by virtue of the C Shares which are entitled to the net assets of LuxCo after payment of dividends and return of capital on the B Prefs and the A Shares. Therefore Barclays will consolidate LuxCo.

6.4.4 The LP and LuxCo Portfolios should be accounted for as "loans and receivables" at amortised cost.

6.4.5 The Forward should be accounted for as a derivative under IAS 39 and fair valued through the consolidated income statement. On the date of declaration of the B Prefs dividend, Barclays should show a pre-tax profit on the Forward equal to the effective gross up under the Forward.

6.4.6 The Luxembourg WHT suffered on the B Prefs dividend should be reflected in the tax line of the consolidated income statement on the date that the dividend is declared as an expense. The Luxembourg WHT relates to the gain on the Forward due to declaration of the dividend and should be recognised as deferred tax which becomes current tax when the WHT is paid.

6.4.7 The A Shares should be treated as debt in the consolidated accounts.

6.5 The Barclays consolidated IFRS position and the Barclays consolidated US GAAP position are expected to be materially the same.

6.6 **Anticipated consolidated LuxBank position**

6.6.1 Under IFRS LuxBank should recognise the Forward as a derivative under IAS 39 and recognise fair value movements on the Forward in its income statement. Until day [t + 15] prior to declaration of the B Prefs dividend, the B Prefs redemption price will be equal to the Forward Price (noting that both can be accelerated at short notice such that any time value of money impact is negligible).

6.6.2 Upon declaration of a dividend on the B Prefs, both the Forward Price payable by LuxBank under the Forward and the B Prefs redemption price will be reduced by the amount of the dividend. The Forward Price will also increase by £[52.5]m in respect of the WHT which becomes payable by LuxBank as a result of the gross up within the Forward Price calculation. However, LuxBank will simultaneously become entitled to a credit of £[52.5]m therefore there will be no net movement in LuxBank's assets and liabilities. LuxBank should recognise a liability in its balance sheet in respect of the WHT gross up payable under the Forward and a receivable in respect of the WHT credit due from the Luxembourg authorities.

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6.6.3 The A Shares should be carried at historic cost with dividends recognised in the income statement when declared.

6.6.4 LuxBank will have voting control of LuxCo and will consolidate LuxCo based on German GAAP. [LuxBank are currently not expecting to consolidate LuxCo under IAS 27]. LuxCo will also be classified as an SPE under SIC-12 and consolidated by Barclays.

## 7. CREDIT AND MARKET RISK

7.1 Barclays will have full management discretion over the LP Portfolio by virtue of an investment management agreement ("IMA") with UKSub which is the general partner of LP.

7.2 The LP and LuxCo Portfolios will consist of reverse repos over OECD sovereign securities.

7.3 Since these assets are highly rated, any credit risk associated with the transaction is expected to be immaterial.

7.4 A credit limit will be marked against the various third party European financial institutions in respect of the reverse repos entered into to source the OECD sovereign securities.

7.5 All necessary credit approvals will be obtained by SCM through GFRM via the normal process.

7.6 Barclays will be exposed to market risk in respect of the interest rate risk on the LP and LuxCo Portfolios. With respect to the LuxCo Portfolio, this risk is not considered to be material given its size and in any case, the reverse repos are anticipated to be short dated. In respect of the LP Portfolio given that the reverse repos are anticipated to be short dated and the loans to LuxBank are anticipated to carry a LIBOR i.e. floating rate of interest, again the risk is not anticipated to be material.

## 8. REGULATORY CAPITAL

8.1 The regulatory capital reporting has been agreed with Finance.

### Basel I

#### 8.2 Barclays solo-consolidated position

8.2.1 MHIML and BIB (IoM) are solo-consolidated. Subsequent to entering into the transaction, both companies should continue to meet the requirements for solo consolidation therefore approval from the FSA should not be required.

#### 8.3 WRAs

8.3.1 There should be no WRAs on either the B Prefs or the C Shares since these are intra-group items.

8.3.2 The Forward with LuxBank can be viewed as a credit derivative which provides BIB (IoM) with credit protection on the B Prefs. In accordance with CD 5.8 (22), it should therefore be ignored for WRA purposes.

8.3.3 However, upon declaration of a dividend on the B Prefs, BIB (IoM) will become entitled to a receivable under the Forward in respect of the

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corresponding gross up therefore counterparty risk should be recognised on this receivable i.e. WRAs of £[10.5]m (20% x £[52.5]m).

#### 8.4 Large exposures

8.4.1 From the time that BIB (IoM) acquires the LP Interest until it is transferred to LuxCo (anticipated to be approximately 5 days), an internal exposure of £[1,122.5]m will arise in respect of the LP Interest. Since this exposure will only last a short period of time, subject to approval from Treasury it is not intended that this will be mitigated.

6.1.1 On day t, internal exposures of £[345.7]m and £[1,122.5]m arise on the C Shares and the B Prefs respectively. LP will guarantee the obligations of LuxCo to redeem the C Shares and the B Prefs and will pledge the £[1,469.1]m LP Portfolio to BIB (IoM) in support of this obligation. Since the LP Portfolio will consist of reverse repos over OECD sovereign securities (which qualify as eligible collateral), the internal exposure on the C Shares and the B Prefs will be mitigated to zero.

8.4.2 In line with CD 10.1 (1), the credit protection on the B Prefs provided by the Forward can also be ignored for WRA purposes. Upon declaration of a dividend on the B Prefs, BIB (IoM) will become entitled to a receivable of £[52.5m] under the Forward. Since the exposure will be for less than one year, this exposure is exempt for the purpose of calculating Barclays' 25% limit.

8.4.3 In order to pay any B Prefs dividend, the LP Portfolio will be partially liquidated, however on the basis that the price at which LuxCo is obliged to redeem the B Prefs will also reduced, it is anticipated that there should still be sufficient eligible collateral within the LP Portfolio to mitigate a significant proportion of the internal exposure on the C Shares and the B Prefs.

8.4.4 To the extent Barclays is required to provide a guarantee (in respect of the obligations of LuxCo and LP) to the counterparties of the repos entered into to source the OECD collateral, such guarantees will give rise to an internal large exposure of Barclays to LuxCo and LP approximately equal to £[51.9]m (£[1,469.1]m x 1.02 x 1.015 - £[1,469.1]m), assuming a 2% haircut.

8.4.5 No large exposure will arise in respect of the CDS given the exposure to the B Shares, under the CDS, will be mitigated by the pledge of eligible collateral under 8.4.2 above.

#### 8.5 Barclays consolidated position

8.5.1 Barclays should consolidate UKSub, LuxCo and LP therefore transactions between these entities should be eliminated for regulatory purposes.

#### 8.6 WRAs

8.6.1 The £[1,469.1]m LP Portfolio will consist of reverse repos over OECD sovereign securities and therefore will attract a 0% risk weighting.

8.6.2 The Forward with LuxBank provides the Barclays Group with second loss credit protection on the LP Portfolio. This protection has not been recognised in calculating the capital required in respect of the LP Portfolio therefore, as at the solus level, the Forward should be ignored for capital adequacy purposes. Similarly to the analysis at the solus level, upon declaration of a dividend on the B Prefs, WRAs of £[10.5]m should be marked in respect of the corresponding receivable under the Forward.

#### 8.7 Large exposures

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8.7.1 The same analysis applies as at the solus level, such that upon declaration of a dividend, an exposure of £[52,5]m to LuxBank arises.

## Basel II

### 8.8 Barclays solo-consolidated position

8.8.1 Barclays has confirmed to the FSA that the Basel II requirements for solo consolidation will continue to be met by both MHIML and BIB (IoM) and therefore they will continue to be solo consolidated under Basel II.

### 8.9 WRAs

8.9.1 WRAs declaration of a B Prefs dividend, WRAs should be marked on the resulting receivable under the Forward with LuxBank and will be modelled using standard Probability of Default, Loss Given Default, Maturity and Exposure at Default inputs.

8.9.2 LuxCo is not part of the UKIG, therefore prima facie solus WRAs will be required to be marked on the C Shares and the B Prefs. However, since LP will pledge OECD securities as collateral in respect of LuxCo's obligations under the C Shares and the B Prefs, this collateral should be taken into account when modelling the applicable risk weighting and should reduce it accordingly. Any unhedged exposure would be risk weighted at 100%.

### 8.10 Large Exposures

8.10.1 The internal exposure on the C Shares and the B Prefs should continue to be mitigated since the LP Portfolio pledged by LP should continue to qualify as eligible collateral.

8.10.2 Any external exposure to LuxBank in respect of the receivable under the Forward should be calculated using the same EAD as for WRA purposes.

8.10.3 The large exposure discussed at 8.4.5 above in respect of any guarantee provided by Barclays to the third party repo counterparties may be as high as £[89.3]m (£[1,469.1]m x 1.02 x 1.04 - £[1,469.1]m) depending on the results of the modelling approach adopted.

### 8.11 Barclays consolidated position

8.11.1 Under Basel II, Barclays should continue to consolidate UKSub, LuxCo and LP. UKSub and LP will be part of the UKIG, however LuxCo will not. Since BIB (IoM) invests debt in LuxCo (which is outside the UKIG) and LuxCo invests in the equity of LP (which is inside the UKIG), the UKIG capital base should be increased.

### 8.12 WRAs

8.12.1 The risk weighting of the LP Portfolio will be modelled using standard inputs. Under Basel II, the definition of collateral still includes OECD sovereign securities. However, for longer dated OECD sovereign securities the applicable haircut may increase by up to 4%. Therefore, the relevant haircut should be taken into account in calculating the Loss Given Default input to the LP Portfolio risk weighting calculation.

8.12.2 The risk weighting of the £[1.1]m LuxCo Portfolio and in respect of the receivable under the Forward, once a dividend has been declared on the B Prefs will also be modelled using standard inputs.

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## 8.13 Large exposures

- 8.13.1 Any external exposure to LuxBank under the Forward or in respect of the collateralised loans to LuxBank within the LP Portfolio should be calculated using the appropriate inputs and methodology.

## 9. PROVISION

- 9.1 It is anticipated that the s.811 deduction and the creditable tax adjustment in the chargeable profits calculation of BIB (IoM) will be subject to an [80]% provision and a [100]% provision respectively.
- 9.2 The table below demonstrates the impact of provisioning on the economic benefit of the Transaction:

	Provision Level					
	S.811 Deduction	Creditable Tax Adj.	S.811 Deduction	Creditable Tax Adj.	S.811 Deduction	Creditable Tax Adj.
	50%	70%	65%	85%	80%	100%
Statutory PBT	46.1		46.1		46.1	
Tax	(16.8)		(16.8)		(16.8)	
Provision	(7.5)	(10.5)	(9.7)	(12.7)	(12.0)	(15.0)
Management Accounts PTE	15.8		9.5		3.2	
PUG	(30.3)		(36.6)		(42.9)	

## 10. CLIENT ENGAGEMENT

- 10.1 Ralf Schneider (Global Head of Equity Sourcing & Structured Products), Estelle Charron (Deputy Head Strategic Solutions) and Hans-Peter Hoffmann (Head of Tax) have been engaged in the origination process of Project Faber and previous transactions with HSH (such as Project Guitar, Project Chronos and Project Athena).
- 10.2 SCM will confirm that the deal has been approved within HSH prior to closing.

## 11. MATERIALITY OF DEAL WITH COUNTERPARTY

- 11.1 The Transaction will generate income of £[2.1]m for LuxBank and tax payable of £[0.4]m. On a consolidated basis, the summary accounts of HSH for 2006 were as follows:

(€m)	2006	2005	2004
Net profit	460	400	127
Equity	7,173	6,800	6,536
Tax (credit) / charge	222	(123)	252
Gross balance sheet assets	189,400	185,056	164,090

- 11.2 Based on 2006 numbers, the Transaction will have a [0.37]% impact on Net Profit, and a [18]% impact on Tax. There should not be a material impact on HSH's balance sheet.
- 11.3 Overall, the Transaction should not have a material impact on the financial statements of HSH.

## 12. OTHER

- 12.1 It is not considered that NPSO signoff will be required.
- 12.2 It is anticipated that Barclay's personnel will be appointed as directors of

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	S.811 Deduction	Creditable Tax Adj.
	50%	70%
Statutory PBT	47.3	
Tax	(18.2)	
Provision	(7.1)	(10.5)
Management Accounts PTE	16.8	
PUG	(30.5)	

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LuxCo [along with a director from HSH]. Although LuxCo is consolidated by Barclays for accounting purposes, it will also be an external LuxBank entity. Confirmation from BCS that the relevant Barclays personnel are covered by the Directors' & Officers' Liability Insurance will be obtained prior to closing [along with the relevant approvals for the HSH director].

## APPENDICES

**Appendix 1** – Detailed Transaction Description

**Appendix 2** – Tax Note from Freshfields

**Appendix 3** – Tax Opinion from Bonn Schmitt Steichen

**Appendix 4** – Detailed Accounting Analysis

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