

To SCM Approvals Committee

From Jonathan Zenios

Date February 2005

Subject Brazilian Investment Strategy

BARCLAYS

1. SUMMARY

Structured Capital Markets (“**SCM**”) is seeking approval to make an investment of £300m in a portfolio of Brazilian Real (“**\$R**”) linked bonds together with associated hedging arrangements. The investments will be made through a specially formed UK tax resident company. The portfolio will be managed by Banco Barclays S.A. (“**BBSA**”).

The benefit of the investment derives from the fact that the BBPLC group will generate pre-tax income at \$R interest rates of c.19% but will not have any exposure to the \$R:GBP exchange rate.

The key financial data is set out below:

Proposed product limit	£600m investment.
Estimated Revenue	c.£[26]m in 2005 – Part year c.£[8]m in 2006 – Part year
Tax capacity <i>Return on Tax capacity</i>	Variable – depends on future \$R:GBP FX rates.
WRAs <i>Return on WRAs</i>	£60m <i>Average c.55%</i>
Balance Sheet <i>Return on Balance Sheet</i>	£300m <i>Average c.11%</i>
PUG	Nil
Tenor	5-years

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

2. TRANSACTION DESCRIPTION *(all transactions assume £1 = R\$5)*

Set-Up Steps – Stage1

- 2.1. Barclays Bank PLC (“**BBPLC**”) acquires the nominal ordinary share capital of an “off-the-shelf”, Cayman Islands incorporated company (“**NewCo**”) that was originally formed in 2004. BBPLC capitalises it with £[300]k of additional ordinary share capital. NewCo invests £[100]k in a portfolio of gilts.
- 2.2. NewCo acquires the nominal ordinary share capital of an “off-the-shelf”, Cayman Islands incorporated company (“**HoldCo**”) that was originally formed in 2004. NewCo capitalises it with £[200]k of additional ordinary share capital. HoldCo invests £[100]k in a portfolio of gilts.

- 2.3. HoldCo acquires the nominal ordinary share capital of an “off-the-shelf”, Cayman Islands incorporated company (“**RealCo**”) originally formed in 2004. HoldCo pays £[100]k for an additional R\$[500]k ordinary share capital in RealCo. RealCo invests £[100]k in R\$-linked assets.
- 2.4. NewCo, HoldCo and RealCo are UK tax resident by virtue of management and control within the UK. The directors of NewCo, HoldCo and RealCo change their first accounting periods to a December 31, 2005 year-end.
- 2.5. NewCo, HoldCo and RealCo prepare their statutory accounts under UK GAAP. NewCo and HoldCo have a GBP functional currency and RealCo has a BRL functional currency.
- 2.6. RealCo enters into an agreement (the “**Services Agreement**”) with BBSA agrees to manage the investments of RealCo including being responsible for the selection of suitable issuers within agreed investment parameters, the application for credit approval and the post-close management of its portfolio. The Services Agreement can be terminated at 5 day’s notice by RealCo’s board of directors.

Set-Up Steps - Stage2

- 2.7. BBPLC invests £300m in redeemable preference shares issued by NewCo (the “**NewCo Prefs**”). The NewCo Prefs are redeemable at both BBPLC’s and NewCo’s option.
- 2.8. NewCo borrows an additional £700m (the “**BB Sub Loan**”) from an existing UK tax resident member of the Barclays group (“**BB Sub**”). The BB Sub Loan pays interest at 3-month GBP LIBOR. The BB Sub Loan can be terminated early at either BBSUB’s or NewCo’s option.
- 2.9. NewCo subscribes £1,000m for R\$5,000m redeemable preference shares (the “**HoldCo Prefs**”). The HoldCo Prefs are mandatorily redeemable in 5 years and earlier at both HoldCo’s and NewCo’s option, either in cash or in-specie (permitting the redemption in a currency other than R\$). The HoldCo Prefs entitle the holder to a cumulative priority dividend (payable in GBP) based on pre-UK tax quarterly Brazilian inter-bank average deposit rates (“**BRLDI**”).
- 2.10. NewCo and HoldCo hedge their BRL exposure by entering into a 5-year cross-currency swap (the “**XCS**”) with the following cashflows:

Initial Exchange

- None

Regular Flows

- NewCo pays GBP amounts linked to BRLDI on a notional principal of R\$5,000m; and
- HoldCo pays 3-month GBP LIBOR on a notional principal of £1,000m;

Final Exchange

- NewCo pays the GBP equivalent of R\$5,000m at the exchange rate in force at termination; and
- HoldCo pays £1,000m.

Both HoldCo and NewCo can accelerate the XCS.

- 2.11. HoldCo lends £700m (the “**HoldCo Loan**”) to BB Sub on exactly the same terms as the BB Sub Loan.

- 2.12. HoldCo subscribes £300m for R\$1,500m of irredeemable equity (the “**RealCo Equity**”). The RealCo Equity entitles HoldCo to a dividend (payable in GBP) equal to the profits of RealCo payable quarterly.
- 2.13. HoldCo hedges the expected \$R-linked dividends on the RealCo Equity by entering into a series of non-deliverable currency forward sale agreements with the markets floor (the “**Market Forwards**”) under which HoldCo agrees to pay fixed \$R-linked amounts in exchange for the GBP equivalents translated at the forward GBP:\$R FX rates.
- 2.14. RealCo invests £300m in \$R-linked bonds issued by third-party non-UK issuers (the “**Bonds**”). The Bonds will have a 1-year tenor and pay interest linked to the 1-year fixed Brazilian interest rate plus the applicable credit spread of the issuer. The Bonds will redeem for the GBP equivalent of R\$1,500m at the exchange rate in force on the redemption date. The Bonds will be issued from MTN programmes.
- 2.15. BBPLC hedges the GBP interest rate risk by entering into a 1-year GBP fixed / floating interest rate swap on a notional of £300m.
- 2.16. BBPLC, NewCo, HoldCo and RealCo enter into a group relief agreement whereby BBPLC and NewCo agree to surrender group relief to HoldCo and RealCo for no payment.

Ongoing Flows

- 2.17. RealCo receives the \$R-linked coupon on the Bonds.
- 2.18. RealCo declares and pays a \$R-linked dividend to HoldCo. Real Co is able to pay 100% of the \$R-linked dividend (as opposed to 70%) since it obtains group relief at no cost from BBPLC or NewCo.
- 2.19. HoldCo uses the \$R-linked receipt from RealCo to make payments under the Market Forwards.
- 2.20. HoldCo receives the GBP equivalent (fixed at outset at the forward FX rate) of the \$R-linked fixed amounts under the Market Forwards.
- 2.21. HoldCo receives 3-month GBP LIBOR interest on the £700m HoldCo Loan and pays 3-month GBP LIBOR interest on the £1,000m XCS.
- 2.22. HoldCo receives the BRLDI linked amounts in GBP under the XCS.
- 2.23. HoldCo pays the dividends on the HoldCo Prefs. HoldCo is able to pay the pre-tax equivalent of the flows set out at 2.18 – 2.22 since it obtains group relief at no cost from BBPLC or NewCo.

Therefore HoldCo has

- a) a hedge of its \$R-linked interest rate risk;
 - b) a hedge of its BRLDI interest rate risk;
 - c) an obligation to pay 3-month GBP Libor on £300m; and
 - d) a fixed stream of GBP cash flows (based on \$R interest rates).
- 2.24. BB Sub receives 3-month GBP LIBOR interest on the BB Sub Loan and pays 3-month GBP LIBOR interest on the HoldCo Loan.

Therefore BB Sub has a hedge of the interest rate risk on the BB Sub and HoldCo Loans.

- 2.25. NewCo receives 3-month GBP LIBOR interest on £1,000m under the XCS.

- 2.26. NewCo pays 3-month GBP LIBOR interest on the £700m BB Sub Loan.
- 2.27. NewCo pays the BRLDI linked amounts under the XCS.
- 2.28. NewCo receives a dividend on the HoldCo Prefs equal to the amounts set out at 2.25-2.27.

Therefore NewCo has

- a) a hedge of its BRLDI interest rate and exchange rate risk; and
 - b) a right to receive 3-month GBP Libor on £300m;
- 2.29. The amounts in 2.23c) and 2.28b) are equal and opposite.

Therefore the net position for the NewCo, HoldCo, RealCo group is a fixed GBP receipt, based on \$R interest rates on the Bonds.

This amount will be taxed and ultimately paid as a dividend to BBPLC.

- 2.30. BBPLC therefore has a fixed rate asset (part profit, part cost of funds) and therefore BBPLC pays fixed under an interest rate swap in order to hedge the GBP Libor funding cost – leaving a fixed profit equal to the spread between (i) \$R rates (translated in GBP at forward rates) on a notional of £300m and (ii) GBP fixed rates on a notional of £300m.

Unwind Steps - Early Termination or Maturity

- 2.31. Each of NewCo, HoldCo and RealCo will close off an accounting period.
- 2.32. The Bonds redeem at maturity, redeem early or are sold by RealCo. RealCo uses the proceeds to make further appropriate investments.
- 2.33. If appropriate RealCo terminates the Services Agreement with BBSA.
- 2.34. HoldCo terminates the XCS. HoldCo may or may not opt to redeem the HoldCo Prefs at the same time.
- 2.35. The BB Sub Loan, the HoldCo Loan, the Market Forwards and the IRS are terminated and repaid.

3. ECONOMICS AND ECONOMIC DRIVERS

- 3.1. This transaction allows BBPLC to earn \$R-linked returns (c.19%) without taking the \$R FX exposure normally associated with a \$R investment.
- 3.2. Each of BBPLC, NewCo, BB Sub and RealCo has an FX hedge on a pre-tax and post-tax basis. The benefit from the transaction manifests itself at HoldCo.
- 3.3. From HoldCo perspective the RealCo Equity and the HoldCo Prefs do not give rise to FX gains or losses for tax purposes, whereas the XCS does give rise to FX gains or losses for tax purposes. If the \$R depreciates against GBP the effect is shown below:

Instrument	Pre-Tax (£)	Tax (£)	Post-Tax (£)
RealCo Equity	(10.0)	0.0	(10.0)
HoldCo Prefs	33.3	0.0	33.3
XCS	(33.3)	10.0*	(23.3)
Total	(10.0)	10.0	0.0

* In order for this hedge to be effective BBPLC must value the tax deduction of 10, i.e. the transaction utilises tax capacity if the \$R depreciates against GBP. The maximum amount of tax capacity that could be used is £1,000m if \$R becomes worthless.

3.4. If the \$R appreciates the effect is shown below

Instrument	Pre-Tax (£)	Tax (£)	Post-Tax (£)
RealCo Equity	10.0	0.0	10.0
HoldCo Prefs	(33.3)	0.0	(33.3)
XCS	33.3	(10.0)*	23.3
Total	10.0	10.0	0.0

* If \$R appreciates against GBP more tax is paid in addition to the profit from the transaction.

3.5. Therefore HoldCo has a post-tax hedged position (regardless of whether \$R depreciates or appreciates against GBP) but is in receipt of \$R-linked income. HoldCo sells the \$R-linked income for GBP income. This is the equivalent of earning \$R-linked income (c.19%) on a £300m investment.

3.6. Attached as Appendix 2 is an analysis based on historical \$R:GBP FX rates, the overall conclusion of which is that tax capacity usage is unpredictable and had similar transactions been executed over the past few years tax capacity would have been generated 48% of the time and utilised 52% of the time.

4. TAX ANALYSIS

NewCo

4.1. The HoldCo Prefs will be treated as capital gains tax assets and therefore any accounting entries in respect of exchange differences will be ignored. HoldCo will suffer capital gains tax on any exchange gains and losses only on disposal.

4.2. The XCS should qualify as a hedge of the HoldCo Prefs for the purposes of Para 4 of the Disregard Regs. This is because:

- (a) although the HoldCo Prefs are treated as debt in NewCo's Solus Accounts the question of what is a "share" for the purpose of Para 4 is a legal and not an accounting test; and
- (b) Condition 3 of Para 4(3) should be satisfied as the XCS eliminates the exposure to exchange differences on the HoldCo Prefs.

The consequences are that any exchange differences arising on the termination of the XCS will be brought into account as capital as and when the HoldCo Prefs are sold or redeemed under SI 2002/1970. These gains and losses will offset the exchange gains and losses on the HoldCo Prefs.

HoldCo

- 4.3. The HoldCo Prefs will not be taxed in HoldCo's hands as they are shares issued by HoldCo and not loan relationships, notwithstanding their treatment as debt under FRS 25 (IAS 32).
- 4.4. Para 4 of the Disregard Regs will not apply to the XCS in HoldCo and therefore the exchange differences will be brought into account in accordance with its solus accounts under the derivative contracts regime. The XCS is hedging the HoldCo Prefs therefore none of the 3 conditions in Para 4 of the Disregard Regs should be met.
- 4.5. The RealCo Equity will be treated as a capital gains tax asset. HoldCo will suffer capital gains tax on any exchange gain or loss only upon disposal.
- 4.6. The Market Forwards will be hedge accounted with the dividends received on the RealCo Equity under UK GAAP. Accordingly HoldCo will not be taxed on the net GBP amounts received.

RealCo

- 4.7. RealCo is a BRL functional currency company. The Bonds are loan relationships and accordingly will be taxed under the FA 1996 regime. RealCo will therefore be taxed on its profits for the year (being the accrual of income on the Bonds) translated into GBP at the average exchange rate for the year.
- 4.8. The overall benefit from the trade will be equal to the \$R-linked income from the Bonds hedged into GBP at the forward FX rates under the Market Forwards. Consequently, if the average FX rate for the year is not equal to the average of the forward FX rates for the year the effective tax rate will not equal 30%. In this case the post-tax profit and hence the management accounts benefit will be different to the pre-tax profit and there will be a corresponding minor PUG impact.

Tax opinion

- 4.9. A tax opinion from Freshfields is attached as Appendix 3.

5. TAX RISK

Unallowable purposes

Para 13, Sch 9, FA 1996

- 5.1. Debits will be recognised on the HoldCo Loan, the BB Sub Loan and BBPLC's funding. However, given that the transaction will generate a pre-tax profit and that for this profit to be earned it is not necessary for the XCS to generate a deductible loss (indeed it may involve additional tax being paid depending on exchange rate movements) it will not be possible to show that the transaction as a whole was entered into with the objective of securing a tax advantage.

Para 23, Sch 26, FA 2002

- 5.2. Debits will be recognised on the XCS and the IRS. For the same reason as set out at 5.1 above Para 23 will not apply.

Non-taxation of the XCS (Mandatory Matching post 1/1/05)

- 5.3. HoldCo's economic gain or loss on the RealCo Equity is hedged on a post-tax basis by the XCS. In circumstances where there is a loss on the XCS, there is a risk of Para 4 of the Disregard Regs applying to the XCS. However, Para 4 of the Disregard Regs should not apply to the XCS since it does not eliminate or substantially reduce the economic risk of holding the RealCo Equity. It is difficult to see how these provisions can be interpreted to apply otherwise than on a pre-tax basis. A pre-tax basis gain or loss on the XCS will, in fact, increase HoldCo's economic exposure to \$R rather than reduce it.

6. ACCOUNTING

6.1. The accounting treatment set out below has been agreed with Financial Control.

RealCo Solus Accounts

- 6.2. RealCo will prepare solus accounts under UK GAAP and will use a \$R functional currency.
- 6.3. RealCo will hold the Bonds on balance sheet at amortised cost and accruals account for interest income which will be taken to P&L.
- 6.4. RealCo will account for the RealCo Equity as equity.

HoldCo Solus Accounts

- 6.5. HoldCo will prepare solus Accounts under UK GAAP and will use a GBP functional currency.
- 6.6. HoldCo will hold the RealCo Equity at cost and not retranslate it since it is a non-monetary item¹.
- 6.7. HoldCo will recognise the HoldCo Prefs as non-equity shares in its first accounting period and as a financial liability under FRS 25 (IAS 32) thereafter. It will contract rate account the XCS with the HoldCo Prefs and therefore recognise no exchange differences on either instrument on a current basis².
- 6.8. If the XCS is terminated at a point in time when the HoldCo Prefs are also redeemed then no amounts will be taken to the Profit and Loss Account. Any cash movements will simply be treated as Balance Sheet movements.
- 6.9. If the XCS is terminated at a point in time when the HoldCo Prefs remain outstanding then the XCS will be retranslated and the exchange difference will be taken to the Profit and Loss Account and offset against the retranslation of the HoldCo Prefs to their current GBP value.
- 6.10. The Market Forwards will be hedge accounted against the dividends HoldCo receives on the RealCo Equity.

NewCo Solus Accounts

- 6.11. NewCo will prepare solus Accounts under UK GAAP and will use a GBP functional currency.
- 6.12. NewCo will account for the HoldCo Prefs and XCS on a symmetrical basis to HoldCo.

BBPLC Solus Accounts

- 6.13. BBPLC will account for the NewCo Prefs as a Loan and Receivable under IAS 39 and hold them at amortised cost.
- 6.14. The IRS will be cashflow hedged against the floating rate funding. The accrual of the fixed cashflows under the IRS will be recognised in the income statement with any fair-value differences recognised in equity.

BBPLC Consolidated Accounts

- 6.15. The Bonds will be recognised as an AFS financial asset and translated into GBP at closing spot rate for inclusion in the Consolidated Accounts. Fair-value gains and losses will be recognised in the AFS portion of Equity by reference to \$R at closing rates.

¹ SSAP 20, para 5

² SSAP 20, para 4

- 6.16. On consolidation exchange gains and losses on the RealCo Equity will be recognised in a separate component of Equity. This is because the RealCo Equity forms part of HoldCo's net investment in RealCo (a foreign operation).
- 6.17. The Market Forwards will be cashflow hedge accounted against the income on the Bonds. Accordingly, the Market Forwards will be fair-valued through Equity. When the income on the Bonds impacts the Consolidated Income Statement an appropriate amount of the changes in the fair value of the Market Forwards will be recycled to the Income Statement. Accordingly, the net income on the Bonds after hedging will be equal to the GBP legs of the Market Forwards received in the particular year.
- 6.18. As a preliminary step in the consolidation of HoldCo and NewCo, it is first necessary to adjust their accounts to an IAS basis from UK GAAP. The HoldCo Prefs will be retranslated into GBP at closing spot rate and exchange differences recognised in each company's IAS Income Statement. Similarly the XCS will be fair valued and the change in fair value recognised, by both companies, in their IAS Income Statements. As the XCS has floating interest rate payments on each leg the substantial majority of these fair value changes will be due to changes in FX rates
- 6.19. As set out above HoldCo will be subject to tax on exchange differences on the XCS but not on the HoldCo Prefs. For NewCo both the HoldCo Prefs and the XCS will be subject to tax as capital gains tax items. The XCS will only be tax effected by HoldCo at termination and accordingly there will be a difference between the tax base of the XCS and its carrying amount. This difference will be equal to the cumulative exchange differences that have arisen to date on the XCS. Accordingly, prior to consolidation a deferred tax asset or liability should be recognised by HoldCo in its pre-consolidation IAS accounts. Overall no net deferred tax asset or liability will be recognised by NewCo as the tax treatment on the HoldCo Prefs and the XCS are symmetrical.
- 6.20. On consolidation the HoldCo Prefs and the XCS will be eliminated from the Consolidated Income Statement and Balance Sheet on the basis that they are intra-group assets/liability and income expense. The deferred tax asset or liability, recognised by HoldCo will not be eliminated. The deferred tax asset or liability will be shown in equity as, in consolidated terms, it relates to the exchanges arising on retranslation of the Net Investment in RealCo.
- 6.21. The funding and the IRS will be accounted for in the Consolidated Accounts on the same basis as in BBPLC's Solus Accounts.

Recycling of FX reserve

- 6.22. At maturity of the \$R investment the Consolidated Accounts will include an FX reserve on account of HoldCo's net investment in RealCo (a foreign operation) and a tax reserve on account of the deferred tax asset or liability recognised by HoldCo on the XCS. Under IAS 21, para 48 these reserves will be recycled to the Income Statement upon disposal of RealCo.

US GAAP analysis

- 6.23. The US GAAP analysis is expected to be broadly the same as the IAS treatment.
- 6.24. An opinion from PwC on the accounting treatment of the transaction will be obtained in advance of execution.

7. CREDIT AND MARKET RISK

- 7.1. RealCo has credit exposure to the issuers of the Bonds and BBPLC (markets) has a credit exposure on the Market Forwards.
- 7.2. If \$R depreciates against GBP, BBPLC is hedged on a post-tax basis by virtue of having taxable profits. If taxable profits are not available, then BBPLC does not have a post-tax hedge. The downside from this eventuality is best illustrated by viewing the table from 3.3 without the tax deduction for the pre-tax loss on

the XCS. In addition to this downside, the cost of creating the conventional pre and post-tax hedge would need to be considered.

- 7.3. Assuming that Bonds are not sold outside of the BBPLC group, but the specifics of the transaction are terminated the exposure to \$R is no longer hedged on a post-tax basis. The cost of creating the conventional pre and post-tax hedge is dependent upon the interest rates at the time of termination. Table A below shows the estimated costs (£'s m) of hedging the sterling principal value of the Bonds on early termination for the given shifts in BRL interest rates, relative to GBP. All necessary credit approvals for RealCo will be obtained by BBSA pursuant to Services Agreement through GFRM. All other credit risks will be obtained by the appropriate business unit via normal routes.

TABLE A

Time since investment	+1%	+2%	+3%	+4%	+5%
3-months	1.2	2.8	4.3	5.8	7.4
6-months	0.5	1.6	2.7	3.7	4.7
9-months	0.1	0.7	1.2	1.7	2.3

8. REGULATORY CAPITAL

The regulatory analysis has been agreed with Finance.

- 8.1. The investment in NewCo Prefs will constitute a £300m large exposure and therefore a utilisation of short-term treasury concession limits.
- 8.2. The NewCo Prefs will not constitute “lending of a capital nature” within the meaning of IPRU CA10.2(b) since the ultimate investment of the BBPLC group is in the Bonds which are likely to be issued by highly-rated financial institutions, have a high credit quality and are redeemable, i.e. it should not be hard to finance this activity from another source.
- 8.3. The issuers of the Bonds are likely to be 20% weighted, hence WRAs of £60m will be consumed initially. The actual annual usage of WRAs will vary in sterling terms given that the Bonds are \$R linked.
- 8.4. In order to equate solus and consolidated WRAs, NewCo could be capitalised with £6m of equity.
- 8.5. The Market Forwards will attract WRA's equal to the CEE plus add-on.
- 8.6. The return on WRA's will average at around 55%.

9. OPERATIONAL ISSUES

- 9.1. None.

10. PROVISION

- 10.1. Given that from inception it is not possible to predict whether more or less tax will be paid a zero provision is suggested.

11. OTHER

- 11.1. It is not considered that NPSO signoff is required for this transaction.

APPENDICES

1. Structure Diagrams;
2. Tax Capacity Analysis; and
3. UK Tax Opinion.