Answer-to-Question-_1_

Loan 1 = 50m
Borrower = Real Estate Plc
Lender = RSK Bank
20 year term, floating rate.
purpose - property

Condition:
20 year floating to fixed interest rate swap on 20m of the principle.
Paid: Interest @ 4%
Received: floating rate

Year 5 = sold property for 60m, paid $10m breakage fee.

Swap - accounting purposes
- what is a swap

Income for years 1 to 5

Taxable profit or loss

In the case of this example, Real Estate Plc (REP) is paying fixed interest to RSK Bank (RSK). This means that the income received by RSK and the interest payments by REP are stable and in line with the fixed interest rate of 4%. However, the bank has required that for £20m of the £50m principle that REP enter into a swap that covers 40% of the loan principle. A swap is a derivative contract, a derivative contract is one where the the value of the contract is priced in relation to an underlying asset, in this case it would be the perceived income stream of REP.

Generally a company would enter into a swap arrangement to minimise interest rate or foreign currency risks (FOREX). The latter is important if one of the parties to the contract operates in a functional currency that differs from that of the lending arrangement. For instance, in this example we know that REP is a UK resident and can assume it operates in sterling but we do not know where RSK Bank is resident. If RSK is resident in a different territory such as the US and its functional currency is US dollars it could deem there to be a FOREX risk and hedge against downward FOREX movements through the swap.

But given that RSK is earning fixed interest and has swapped it with a floating interest, they would be entering an interest rate swap which means that they have concerns over the interest rate movements over the coming years and would like to hedge against interest rate movements.

There are issues with derivative contracts from a tax point and accounting point of view as they can result in the value of the underlying asset changing and can lead to banks incurring unrealised gains or losses on swaps. This is because the swap element of the loan will be recognised on both RSP and REP's balance sheets at fair value. The loan would then be revalued at the end of each accounting period and the new value being recorded - with any upwards or downwards movement being seen as a gain or loss.

As REP is a UK resident they are governed by the tax rules in CTA09 and CTA10, amongst other areas of legislation. UK tax rules state that profits from derivatives are treated as income and not capital. The income or losses from derivative contracts would normally then be recorded in the tax return as a debit or credit for loan relationships.

REP's income for years 1 to 5 will be: I have assumed here there has been a deduction for the interest expense as the question states "after payment of expenses" for the Net rent figure.

	Year 1	Year 2	Year 3	Year 4	Year 5
Net Rent	2,500,000	2,500,000	2,500,000	2,500,000	2,500,000
Adjustment for Swap Income (Loss)	(500,000)	0	250,000	(500,000)	(500,000)
Adjusted income	2,000,000	2,500,000	2,750,000	2,000,000	2,000,000

When selling the property REP incur a breakage fee, which is a fee charged by a lender for a borrower exiting a contract early. In this case the contract was for 20 years but the borrower, REP, exited the contract after 5 years. This fee is meant to compensate the lender for the lost income from the lending ending early. If the company can demonstrate that this was for business purposes they can claim the fee as a deduction in the UK. It normally be expected to be included in the fair value of the property as it would be seen as a cost of sale. That would make the sale of the property:

Sale price: £60m
Outstanding loan amount:
50m * 4% = 2,000,000 * 5 = 10m. 50m - 10m = 40m.
Breakage fee: £10m
Total deduction = 50m
Profit = 10m

The company does not receive any additional deductions for the swap losses as these were already treated as income in earlier periods.

Answer-to-Question-_2_

House builder. Issued convertible bonds - value £10m. 3 years no coupon. 25% discount. After 3 years convert £100 loan ntoe into 100 £1 ordinary shares as fully paid.

UK homes Ltd shares = 70p at issue.
1 year after= 105p
2 years = 110p
3 years all investors converted to shares.

A convertible bond is a compound instrument for the issuer but a hybrid instrument for the investor. It is a compound instrument because it has both financial and equity attributes, whereas a hybrid has financial and an underlying derivative attribute, which for the investor is the initial bond and the derivative aspect is the conversion to shares and their underlying asset value.

A company would issue convertible securities when it is not in a position to borrow at favourable rates, this may be because it has a low credit rating due to previous poor performance or being a start up. An investor would consider convertible securities as a gamble, where they would pay less at the outset but get a bigger reward (i.e. company shares) at the end as they expect the company to perform well and grow. It can be lower risk as they have the option to turn it into cash as well.

For the Issuer
As a convertible bond is a compound instrument under FRS 102 it will be recognised on both the balance sheet and P&L account for the issuing company (UK homes Limited (UKHL). However there will be two instances on the balance sheet for the convertible bond, the first would be the liability for the bond itself and the second would be equity value to convert the bonds to shares i.e. a call option.

It will be recognised in the balance sheet at fair value for the aspect relating to the bonds. This amount will then be subtracted from the fair value of the instrument as a whole to ascertain the value of the equity aspect.

In subsequent periods liability aspect will be valued on an amoritsation basis with any gains or losses being reflecting as income in the P&L.

The equity aspect will stay the same until an option to convert is called in. In which the company will then convert the liability component to an equity component. With the initial equity component remaining unchanged.

For the Investor
The convertible bond is a hybrid instrument for the investor. If the investor is a UK resident and company they are governed by the tax rules in CTA09 and CTA10, amongst other areas of legislation. UK tax rules state that profits from derivatives are treated as income and not capital. The income or losses from derivative contracts would normally then be recorded in the tax return as a debit or credit for loan relationships.

They would recognise the whole instrument at fair value in their accounts on subscription and treat any gains or losses on revaluation at accounting period end in the p&l.

On conversion to equity they would claim amortisation with the UK would seek to disallow and the new shares gained would fall under the capital gains rules with an acquisition at fair value of conversion.

UKHL Years 1 -3

Year 0:
Fair value of convertible bond = £10m
Fair value of liability component = £7m
Fair value of equity component = £3m

Year 1:
As the price of the shares has gone up UKHL would revalue the liability aspect of the bond and include any gain in that valuation in their P&L.

Fair value of liability component = 10,500,000
Gain = 3,500,000 treated as income in P&L

Year 2:
Fair value of liability component = 11,000,000
Gain = 500,000 treated as income in P*L

Year 3:
Fair value of liability component = 11,000,000
Converted to equity of 11,000,000
Amortisation in P&L of 11,000,000

Investors holding:

Year 0:
Fair value of convertible bond = £10m

Year 1:
Fair value of bond = 10,500,000
gain of 500,000 in P&L

Year 2:
Fair value of bond = 11,000,000
gain of 500,000 in P&L

Year 3:
Fair value of bond = 11,000,000
Converted to equity of 11,000,000
Amortisation in P&L of 11,000,000

Answer-to-Question-_4_

Under the Basel Framework, specifically Basel III, banks are required to meet capital adequacy requirements.

Tier 1 capital is defined as free capital that is there to absorb losses without impacting on the banks ability to operate. It can be broken down into:

- Common Equity tier 1 capital (CET1)- which are generally ordinary shares and retained earnings. Two assets which are liquid and allow greater loss absorbtion.
- Additional Tier 1 capital (AT1) - which are other assets, less ability to absorb losses but can generally be converted to Tier 1.

the capital requirements are usuall based on risk-weighted assets which are generally the % of risk held against the assets.

Under Basel III a banks minimum capital adquacy ratio is 10.5% of which 6% is made up of Tier 1 capital (4.5% CET1, 1.5% AT1), with 2% being tier 2 capital and then capital contribution buffer of 2.5%.

In the case of the UK bank they have determined their minimum capital adequacy ratio to be 15% of which 7.5% needs to be Tier 1 capital.

Before BCB enters into the arrangement with the UK bank its Tier 1 capital is:

Tier 1 capital / Risk weighted assets.

10/200 = 5%. This is below the 7.5% necessary. Therefore it does not meet its capital adequacy requirements.

After the the investment by the Bordonian Central Bank (BCB) its Tier 1 capital is:

Tier 1 capital = 10+15 = 25m

RWAs = (200*50%)+ 115m = 215m
(as you add the additional loans made to the asset amount)

25m/215m = 11.63%.

So after the arrangement the UK bank satisfies its Tier 1 capital adequacy requirements.

There may be some legal hurdles that need to be cleared for the proposed investment. Such as:

The shares issued to BCB must be ordinary shares and they must be easily converted or called in.

The loan agreement between BCB and the UK would need specific conditions. If BCB want to use it for their capital adequacy requirements they would ask for it to be able to be written off.

There is also a concern that since the loan is between two banking entities there could be additional risk exposed to the UK entity. There is also a potential issue of double dipping as it is a circular transaction as both the banks could be treating the loan and subsequent shares as Tier 1 capital - so their risks are intertwined and treated as an asset for both, but no subsequent liability.

If BCB are acquiring shares in the UK bank, do they already hold shares and would the acquisition of these new shares give them a minority interest? This could then result in the capital adequacy of the bank changing as you would need to consider new group consilidation and figures.

Answer-to-Question-_5_

In response to the 2008 financial crash, various steps were taken by governments and regulators to ensure that it could not occur again. One outcome of this was the adoption of Basel III which required banks to hold specific levls of capital (8% of risk weighted assets) to absorb losses in times of stress such as bank-runs (people withdrawing their cash). It also introduced stricter risk control within the banks and liquidity requirements. These requirements have been enshrined by some tax agencies in the banking rules.

The UK also introduced the code of practice on taxation for banks to reduce risky tax planning by banks and ensure they fully comply with the tax obligations. Allowing banks to approach them to discuss their proposed tax affairs.

Governments introduced the above through their regulators but they also took tax approaches such as:

The UK's bnk levy which came into effect in 2011.

- This was a charge every accounting period on banks operating in the UK through a resident company or a branch of a foreign bank.
- The charge is raised on balance sheet items of the banking groups, normally consolated accounts, but this can change depending on the type of banking entity. There is deminimis in that no levy will arise on the first £20bn of chargeable liabilities int he balnce sheet.
- The purpose of the levy was to encourage banks to move to less risky funding models which is why it targets certain balance sheet items.
- Double taxation relief is available in the UK where UK banking groups have incurred a banking levy in other countries. This is negotiated outside of the double taxation agreements and there are currently two in place with france and Germany.

Other countries have introduced their own levies, following the advice of economic organisations.

HMRC (UK tax agency) have also introduced a banking surcharge on the profits of banking entities. Which is a charge on top of corporation tax. The purpose of this charge is to reflec the risk banks pose to the global economy, with the government stating they should pay more tax to reflect this but also the impact that the 2008 financial crash had.

Tax agencies have also adopted, some into their legislation such as Germany, the authorised OECD approach (2010 AOA) which outlines strict rules for how banks should operate in countries through PEs and how they should report their profits in them, but also the capital and liquidity requirements they should follow. The OECD's transfer pricing guidelines also refer to the AOA on banking organisations through a footnote. Part II of the AOA covers banking PEs.

There have also been introductions of information sharing mechanisms such as DAC6 and country by country reporting by tax agencies to share with treaty partners information on the tax affairs of resident entities so risks can be better identified and adressed.

Answer-to-Question-_8_

A share buyback is when a company purchases its shares back of their holders. Doing this reduces the amount of shares in circulation. They do this as it:

- Increases the value of the shares still in circulation
- reduces the possibility that another party may gain controlling majority
- utlises excess capital

A company may have limits on the amount of shares it is able to issue. Buying back shares allows it to then issue additional shares again as part of employ share schemes or to raise additional capital at a later point. For that latter they may buyback shares before making an announcement that they expect will increase their share value.

Shareholders will also be present on the board, and reducing the amount of other individuals that hold shares would lead to the remaining shareholders receiving larger dividends.

If Mr Jones takes up the offer the banks reserves will look like:

Share Capital: £1 ordinary shares: £1,950,000
Share Premium: £3,800,000
Reserves: 7,500,000
Total: 13,250,000

Mr Jones will receive:

1,000 shares @ £10 a share = £10,000
Bought for £4 a share = 4,000 purchase price
Gain = 6,000

Under UK law a share buy-back is treated as a dividend for tax purposes so he will pay tax on the lower rate of 33.75%. The tax is on gain after purchase price is taken into account. Mr Jones will pay:

Tax: £2,025
Receive: £3,975

Impact on capital adequacy ratio:

The transaction will impact the banks capital adequacy ratio by reducing the amount of tier 1 capital it holds. This is because the amount of issued £1 ordinary shares it has will be reduced.

Before:
Capital adequacy (CAR) = 14/95m = 14.74%

After:
CAR = 13.25m/95m = 13.95%

Which means the bank does not meet its CAR requirements and would need to seek additional funding eslewhere. Either through issuing more shares or alternatives. It would not be a good decision for them.

---------DO-NOT-EDIT-THIS-DIVIDER------