

**Exhibit 04-7A, Addendum**

Example 3

***Introduction***

The staff understands that many opponents of View C for Issue 1 do not believe that it is operational as it will be difficult to capture all of the variability (the fair value variability absorbed by some instruments and the cash flow variability absorbed by other instruments) in a computation of expected losses and expected residual returns as contemplated by Appendix A in FIN 46R. The staff understands these concerns and expects that in order to capture all of the variability in a VIE, it may be necessary to prepare separate computations on expected losses and expected residual returns for interests that absorb fair value variability and for instruments that absorb cash flow variability. The following illustrates an example transaction and one methodology that could be used to perform this analysis under View C of Issue 1:

***Facts and Assumptions***

Assume a VIE is created as an investment vehicle for a group of investors with the intention of obtaining fixed and floating rate investments in investment grade securities. The VIE is financed with \$1 million of 1-year floating-rate (180-Day LIBOR) debt from investors and \$1 million of 1-year fixed-rate (2.175%) debt from other investors. The floating-rate debt is senior to the fixed-rate debt. The VIE's best investment alternative is to use the proceeds to purchase \$2 million of 1-year investment grade floating rate securities (180-Day LIBOR). At the time of the formation of the entity, the VIE enters into a \$1 million notional amount interest rate swap with a AAA rated counterparty, for which the VIE receives a fixed rate (2.175%) of interest and pays a floating rate (180-Day LIBOR) on the same notional amount. The interest rate swap is entered into to address the interest rate mismatch caused by the VIE's purchase of floating rate assets to back the issuance of fixed-rate debt. The terms of the swap are customary in these types of transactions. The transaction was marketed to potential investors as an investment in fixed and floating rate assets. The interest rate swap counterparty is senior to both of the debt holders. There is no default risk assumed for the counterparty to the interest rate swap.

Credit risk, if it exists, should not be ignored when calculating expected losses and expected residual returns and when determining those interests that create variability versus those that absorb it. In this example we have assigned a level of credit risk to each scenario as follows: In Scenario 1 there are no anticipated credit losses, Scenario 2 assumes credit losses equal to 0.25% of the securities purchased, Scenario 3 assumes credit losses equal to 0.5% of the securities purchased, and Scenario 4 assumes credit losses equal to 3% of the securities purchased.

***Variability of the Variable Interest Entity***

The following is a summary of those interests that create variability (that is, expected losses) for the VIE:

- Cash flow variability associated with the floating rate of return on the \$2 million of investments purchased
- Fair value variability associated with the receive fixed-rate leg of the \$1 million notional interest rate swap
- Variability due to issuer default on the floating rate investments purchased.

The following is a summary of those interests that absorb variability created by the interests listed above (that is, the variable interests):

- \$1 million of Fixed-Rate Debt
- \$1 million of Variable-Rate Debt
- Pay-variable Leg of the \$1 million Notional Interest Rate Swap

After considering the waterfall of the cash flows to be disbursed to each party involved, it has been determined that the VIE's risks/sources of variability are absorbed in the following manner:

- Interest rate swap counterparty (dealer), through its receipt of the pay-variable leg of the interest rate swap, absorbs a portion of the cash flow variability associated with the variable payment stream received from the investment securities purchased.
- Variable rate debt holders absorb a portion of the cash flow variability associated with the variable payment stream received from the investment securities purchased

- Fixed rate debt holders absorb the fair value variability created by the received fixed-rate leg of the interest rate swap as well as the credit risk associated with the investments purchased.

**NOTE:** For the purpose of the illustrative expected losses and expected residual returns calculation and the illustrative allocation of expected losses and expected residual returns to variable interests provided, the present value of the expected cash flows does not equal the par on any instrument in the example. This is because the interest rates used do not incorporate the credit risk assumed in the example. The staff notes that the present value of the expected cash flows on the \$2 million variable-rate investments approximates the present value of the expected cash flows of the fixed- and variable-rate debt issued.

***Illustrative Expected Losses and Expected Residual Returns Calculation***

The following computation of entity-wide expected losses, expected residual returns, and expected variability is intended to provide guidance consistent with the illustration provided in Appendix A of FIN 46(R), and should not be considered the only possible method.

Fair Value Variability of Receive 2.175% Fixed-Rate Leg of \$1 Million Interest Rate Swap

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Estimated Loss Due to Default<sup>1</sup></u>	<u>Probability</u>			
1	1.50 %	\$0	10%			
2	1.75	\$0	40			
3	2.00	\$0	40			
4	2.25	\$0	10			

  

<u>Scenario</u>	<u>End of 1 yr Estimated Cash Flows<sup>2</sup></u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows<sup>3</sup></u>	<u>Expected Probability</u>	<u>PV of Expected Cash Flows</u>
1	\$1,021,750	1.50%	\$1,006,650	10%	\$ 100,665
2	1,021,750	1.75	1,004,177	40	401,671
3	1,021,750	2.00	1,001,716	40	400,686
4	1,021,750	2.25	999,267	10	99,927
					<u>\$ 1,002,949</u>

  

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,006,650	\$1,002,949	\$ 3,701	10%	\$ -	\$ 370
1,004,177	1,002,949	1,228	40	-	491
1,001,716	1,002,949	(1,233)	40	(493)	-
999,267	1,002,949	(3,682)	10	(368)	-
				<u>\$ (861)</u>	<u>\$ 861</u>

<sup>1</sup> Estimated loss due to default relating to the swap counterparty is assumed to be \$0.

<sup>2</sup> The end of year estimated cash flows include \$1,000,000 of notional as it is depicting the expected losses and expected residual returns of the VIE as a whole.

<sup>3</sup> Cash flows are discounted in each scenario using a discount rate equal to the corresponding one-year risk free rate that could have been earned under that scenario in lieu of the fixed rate actually earned.

**Addendum to Exhibit 04-7A**

Cash Flow Variability of \$2 Million of 180 Day LIBOR Variable Rate Investments

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Average 180-Day LIBOR</u>	<u>Estimated Loss Due to Default<sup>1</sup></u>	<u>Probability</u>
1	1.875%	1.80%	\$0	10%
2	1.875	2.05	(5,000)	40
3	1.875	2.30	(10,000)	40
4	1.875	2.55	(60,000)	10

  

<u>Scenario</u>	<u>End of 1 yr Estimated Cash Flows<sup>2</sup></u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows<sup>3</sup></u>	<u>Expected Probability</u>	<u>PV of Expected Cash Flows</u>
1	\$2,036,000	1.875%	\$1,998,528	10%	\$ 199,853
2	2,036,000	1.875	1,998,528	40	799,411
3	2,036,000	1.875	1,998,528	40	799,411
4	1,991,000	1.875	1,954,356	10	<u>195,436</u>
					\$ 1,994,111

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,998,528	\$1,994,111	\$ 4,417	10%	\$ -	\$ 442
1,998,528	1,994,111	4,417	40	-	1,767
1,998,528	1,994,111	4,417	40	-	1,767
1,954,356	1,994,111	(39,755)	10	<u>(3,976)</u>	<u>-</u>
				\$ (3,976)	\$3,976

<sup>1</sup> Estimated losses due to default are assumed to be: 0% with a 10% probability; 0.25% with a 40% probability; 0.5% with a 40% probability; and 3% with a 10% probability, in this example.

<sup>2</sup> The end of Year 1 estimated cash flow is calculated by adding the interest (calculated by multiplying the principal amount outstanding by the average LIBOR rate for the scenario) to the principal amount and subtracting the amount of default for the scenario.

<sup>3</sup> Cash flows are discounted in each scenario using a single discount rate equal to the current one-year risk free rate of 1.875%.

Summary of Entity-Wide Expected Losses and Expected Residual Returns

The following is a summary of the present value of the estimated cash flows of the VIE compared to the present value of the expected cash flows and the probability of the estimated cash flows used to arrive at the VIE's expected loss and expected residual returns.

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$3,005,178	\$2,997,060	\$ 8,118	10%	\$ -	\$ 812
3,002,705	2,997,060	5,645	40	-	2,258
3,000,244	2,997,060	3,184	40	-	1,274
2,953,623	2,997,060	(43,437)	10	<u>(4,344)</u>	<u>-</u>
				\$(4,344)	\$4,344

The staff determined the Summary of Entity-Wide Expected Losses and Expected Residual Returns by aggregating the expected losses and expected residual returns for all creators of variability under each scenario. This is one example of how to aggregate these amounts. The staff observes that other methods may exist to summarize Entity-Wide Expected Losses and Expected Residual Returns.

***Illustrative Allocation of Expected Losses and Residual Returns to Variable Interests***

The following calculations are used to determine how much of the entire entity's variability each of variable interests is expected to absorb. An allocation of the expected cash flows to be received by the VIE is performed according to the seniority of each variable interest as follows:

Scenario	End of Year 1 Est. Cash Flows	Swap Party	Floating Debt	Fixed Debt
1	\$3,057,750	\$1,018,000	\$1,018,000	\$1,021,750
2	\$3,057,750	\$1,020,500	\$1,020,500	\$1,016,750
3	\$3,057,750	\$1,023,000	\$1,023,000	\$1,011,750
4	\$3,012,750	\$1,025,500	\$1,025,500	\$961,750

**Cash Flow Variability of Pay Variable 180 Day LIBOR Leg of \$1 Million Interest Rate Swap**

Scenario	Risk Free Rate	Average 180-Day LIBOR	Estimated Default Loss to be Absorbed <sup>1</sup>	Probability
1	1.875%	1.80%	\$0	10%
2	1.875	2.05	0	40
3	1.875	2.30	0	40
4	1.875	2.55	0	10

Scenario	End of 1 yr Estimated Cash Flows <sup>2</sup>	Disc. Rate	PV of Est. Cash Flows <sup>3</sup>	Expected Probability	PV of Expected Cash Flows <sup>4</sup>
1	\$1,018,000	1.875%	\$999,264	10%	\$ 99,926
2	1,020,500	1.875	1,001,718	40	400,687
3	1,023,000	1.875	1,004,172	40	401,669
4	1,025,500	1.875	1,006,626	10	<u>100,663</u>
					\$1,002,945

PV of Estimated Cash Flows	PV of Expected Cash Flows	Diff.	Probability	Expected Losses <sup>4</sup>	Expected Res. Returns <sup>4</sup>
\$999,264	\$1,002,945	\$ (3,681)	10%	\$ (368)	\$ -
1,001,718	1,002,945	(1,227)	40	(491)	-
1,004,172	1,002,945	1,227	40	-	491
1,006,626	1,002,945	3,681	10	-	<u>368</u>
				<u>\$ (859)</u>	<u>\$ 859</u>

<sup>1</sup> Estimated default loss to be absorbed related to the swap counterparty is assumed to be \$0.

<sup>2</sup> The end of year estimated cash flows include \$1,000,000 of notional as it is depicting the expected losses and expected residual returns of the VIE as a whole.

<sup>3</sup> Cash flows are discounted in each scenario using a single discount rate equal to the current one-year risk free rate of 1.875%.

<sup>4</sup> The present value of expected cash flows (that is, fair value) and expected losses and expected residual returns for the pay variable leg of the swap is approximately equal to the corresponding amounts computed earlier for the receive fixed leg of the swap.

**Addendum to Exhibit 04-7A**

Fair Value Variability of \$1 Million of 2.175% Fixed Rate Debt

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Estimated Default Loss to be Absorbed<sup>1</sup></u>	<u>Probability</u>
1	1.50 %	\$0	10%
2	1.75	\$(5,000)	40
3	2.00	\$(10,000)	40
4	2.25	\$(60,000)	10

<u>Scenario</u>	<u>End of 1 yr Estimated Cash Flows</u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows<sup>1</sup></u>	<u>Expected Probability</u>	<u>PV of Expected Cash Flows</u>
1	\$1,021,750	1.50%	\$1,006,650	10%	\$ 100,665
2	1,016,750	1.75	999,263	40	399,705
3	1,011,750	2.00	991,912	40	396,765
4	961,750	2.25	940,587	10	94,059
					<u>\$ 991,194</u>

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$1,006,650	\$991,194	\$15,456	10%	\$ -	\$ 1,546
999,263	991,194	8,069	40	-	3,228
991,912	991,194	718	40	-	287
940,587	991,194	(50,607)	10	<u>(5,061)</u>	<u>-</u>
				<u>\$ (5,061)</u>	<u>\$ 5,061</u>

<sup>1</sup> Estimated default loss is solely absorbed by the fixed-rate debt instruments due to the relative subordination of these instruments to the other instruments.

<sup>2</sup> Cash flows are discounted in each scenario using a discount rate equal to the corresponding one-year risk free rate that could have been earned under that scenario in lieu of the fixed rate actually earned.

Cash Flow Variability of \$1 Million of 180 Day LIBOR Variable Rate Debt

<u>Scenario</u>	<u>Risk Free Rate</u>	<u>Average 180-Day LIBOR</u>	<u>Estimated Default Loss to be Absorbed<sup>1</sup></u>	<u>Probability</u>
1	1.875%	1.80%	\$0	10%
2	1.875	2.05	0	40
3	1.875	2.30	0	40
4	1.875	2.55	0	10

  

<u>Scenario</u>	<u>End of 1 yr Estimated Cash Flows</u>	<u>Disc. Rate</u>	<u>PV of Est. Cash Flows<sup>2</sup></u>	<u>Expected Probability</u>	<u>PV of Expected Cash Flows</u>
1	\$1,018,000	1.875%	\$ 999,264	10%	\$ 99,926
2	1,020,500	1.875	1,001,718	40	400,687
3	1,023,000	1.875	1,004,172	40	401,669
4	1,025,500	1.875	1,006,626	10	<u>100,663</u>
					\$ 1,002,945

<u>PV of Estimated Cash Flows</u>	<u>PV of Expected Cash Flows</u>	<u>Diff.</u>	<u>Probability</u>	<u>Expected Losses</u>	<u>Expected Res. Returns</u>
\$ 999,264	\$1,002,945	\$ (3,681)	10%	\$ (368)	\$ -
1,001,718	1,002,945	(1,227)	40	(491)	-
1,004,172	1,002,945	1,227	40	-	491
1,006,626	1,002,945	3,681	10	<u>-</u>	<u>368</u>
				\$ (859)	\$ 859

<sup>1</sup> Estimated default loss to be absorbed is \$0 due to the seniority of the floating-rate debt instruments.

<sup>2</sup> Cash flows discounted in each scenario using a single discount rate equal to the current one-year risk free rate of 1.875%.

Allocation of Entity-Wide Expected Loss and Expected Residual Returns to the Variable Interests

	<u>Expected Losses</u>	<u>Expected Residual Returns</u>
\$1 million of Variable Rate Debt	\$ (859)	\$ 859
\$1 million of Fixed Rate Debt	(5,061)	5,061
Variable Leg of \$1 million interest rate swap	<u>(859)</u>	<u>859</u>
Total for VIE	\$( 6,779)	\$6,779

**In this case, the staff observes that the sum of the expected losses and expected residual returns of the variable interest exceed that of the VIE. The staff acknowledges that many ways of dealing with this have developed in practice, but notes that this is outside of the scope of this Issue. However, in regards to the VIE being analyzed in this example, it is clear that the fixed rate debt instrument would absorb a majority of the expected losses and expected residual returns of the VIE.**

The above allocation illustrates one technique that can be used to allocate the expected losses and expected residual returns of the VIE to its variable interests. This does not preclude an evaluating enterprise from using a different technique. The staff notes that not prescribing a technique to allocate these amounts is consistent with paragraph D34 of FIN 46R, which states "The Board decided not to specify a single technique for analysis of variable interest entities or otherwise limit an enterprise's ability to choose the technique it believes applies in its own specific circumstances, but it may choose to do so in the future."