

- The Financial Accounting Standards Board (FASB) issued Exposure Draft 1201-100 on June 23, 2004, to provide proposed guidance about how entities should determine fair value estimations for financial reporting purposes. The main concepts of the Exposure Draft are explained below.

Fair Value Hierarchy	
<b>Level I</b>	Requires the use of quoted prices from an active market for identical assets or liabilities. To use this level, the entity must have immediate access to the market (could exchange in current condition). If more than one market is available, the exposure draft requires the use of the “most advantageous market.” Both the price and costs to do the transaction must be considered.
<b>Level II</b>	Requires the use of quoted prices for similar assets or liabilities in active markets. While in Level One an entity is not permitted to make any change to the quoted price, an entity may make price adjustments, as necessary, in Level Two since the assets or liabilities are only similar, not identical. It is stated, however, that any adjustment must be objective. If the adjustment is not objective or there are no similar goods in the active market, an entity must measure the fair value based on Level Three.
<b>Level III</b>	This level requires the use of valuation techniques. The draft suggests the use of the market, income, and cost approach, unless the use of all three produces undue costs and effort. If that is the case, an entity is to use the approach that produces the best approximation of the fair value. Inputs used to determine the value should be external to the entity. The entity may only rely on internal information if the cost and effort to obtain external information is too high.

- As of the Q1 2008 reporting period, Bear Stearns, Morgan Stanley, Lehman Brothers, Merrill Lynch and Citigroup’s Level III assets to equity was 314, 235, 171, 130 and 117 percent respectively.

- This table shows the \$312 billion in asset writedowns and credit losses since the beginning of 2007, including reserves set aside for bad loans, at more than 70 of the world's largest banks and securities firms.
- Only writedowns and provisions that have filtered through to the income statement are included. Asset value reductions that some banks preferred to keep on their balance sheet and not charge against earnings are excluded.
- The International Monetary Fund and other institutions have estimated that total financial losses due to the current credit crisis could reach \$1 trillion.

Firm	Writedowns (\$bb)	Credit Loss (\$bb)	Total (\$bb)
Citigroup	35.3	5.6	40.9
UBS	38.0	-	38.0
Merrill Lynch	31.7	-	31.7
Royal Bank of Scotland	14.9	-	14.9
Bank of America	9.2	5.7	14.9
Morgan Stanley	12.6	-	12.6
HSBC	3.0	9.4	12.4
JPMorgan Chase	5.5	4.2	9.7
Credit Suisse	9.6	-	9.6
IKB Deutsche	9.0	-	9.0
Washington Mutual	0.3	8.0	8.3
Deutsche Bank	7.4	-	7.4
Wachovia	4.9	2.4	7.3
Credit Agricole	6.5	-	6.5
Mizuho Financial Group	5.4	-	5.4
Canadian Imperial (CIBC)	4.1	-	4.1
Societe Generale	3.8	-	3.8
Bayerische Landesbank	3.6	-	3.6
Wells Fargo	0.9	2.7	3.6
E*Trade	2.5	0.9	3.4
Lehman Brothers	3.3	-	3.3
Barclays	3.3	-	3.3
WestLB	3.2	-	3.2
Bear Stearns	3.2	-	3.2
National City	0.5	2.6	3.1
Goldman Sachs	3.0	-	3.0
Dresdner	2.7	-	2.7
Normura Holdings	2.5	-	2.5
ABN Amro	2.4	-	2.4
Fortis	2.3	-	2.3
HSH Nordbank	2.3	-	2.3
Bank of China	2.0	-	2.0
LB Baden-Wuerttemberg	2.0	-	2.0
Natixis	1.9	-	1.9
BNP Paribas	1.3	0.3	1.6
UniCredit	1.6	-	1.6
DZ Bank	1.5	-	1.5
Caisse d'Epargne	1.3	-	1.3
Gulf International	1.0	-	1.0
European Banks Not Listed Above	9.4	-	9.4
Asian Banks Not Listed Above	6.9	0.4	7.3
Candian Banks Not Listed Above	2.8	0.9	3.7
<b>Total</b>	<b>268.6</b>	<b>43.1</b>	<b>311.7</b>

Source: Bloomberg

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- **Absent Demand Market**

- According to Bloomberg, the return demanded for agency mortgage bonds over 10-year U.S. Treasuries has widened to the largest margin in over 22 years. This has been primarily caused by a significant lack of demand for mortgage-backed securities. The majority of available money to purchase mortgage-backed securities is waiting on sidelines until the credit crisis subsides. Large foreign investors and other players are not comfortable with the decision to deploy significant capital into the current market. This has caused an increase in the bid/ask spread.
- Hedge funds & SIVs (“Special Investment Vehicle”) have provided the majority of demand prior to the credit crisis. The leveraged nature of hedge funds and SIVs amidst the artificial fall of security prices due to absent demand have caused many hedge funds and SIVs to unwind without reasonable financing costs and the inability to post the capital to meet margin calls. This, in turn, has caused additional supply and less demand pushing bond prices even lower.
- Example: One of The Carlyle Group’s funds was forced to unwind its holdings after it received default notices from its lending banks after failing to meet four of its seven margin calls. A week later, its lenders seized its assets, sending the fund into insolvency. John Stomber, the CEO of Carlyle Capital, said **counterparties were demanding margin prices that did not represent the underlying recoverable value of the fund’s assets.** Carlyle Capital’s investments are all AAA-rated securities issued by Fannie Mae, Freddie Mac and Ginnie Mae. (Source: The Independent)

- **Evidence of a Recovering Demand Market**

- Despite current poor demand, the demand for AAA-rated paper has seen some improvement. Just a few months ago AAA-rated paper was trading between 60 and 70 cents on the dollar. Today, this has risen 10 to 15 cents to between 70 and 80 cents on the dollar. Yet, this paper, based on the projected cash-flows would arguably be trading 15 to 20 cents on the dollar higher in a normal demand environment.

Will the conservative nature of auditors and regulators cause unrealized gains in the future due to inappropriate writedowns in AAA-rated paper?

### Valuation

Collateral Type	Subprime	Jumbo A-Paper
Product Type	Adjustable-Rate	Fixed-Rate
Vintage	2004	2007
Moodys Rating	Baa2	n/a
S&P Rating	BBB-	AAA
Fitch	B	AAA
<b>Ask Price</b>	<b>~\$20</b>	<b>~65</b>
<b>Cash Flow Valuation Price</b>	<b>~\$10</b>	<b>~76</b>

### Modeling Assumptions

Loss Severity	60 Percent	50 Percent
CPR	10 Percent	15 Percent
CDR	15 Percent	3 Percent
Discount Rate	40 Percent	15 Percent