The Subprime Effect:
Keys to Minimize the Impact to Your Business

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The Subprime Formula

Bad life event (job loss, divorce, sickness)

\+ Bankruptcy, foreclosure, serious delinquency or default

= FICO <620

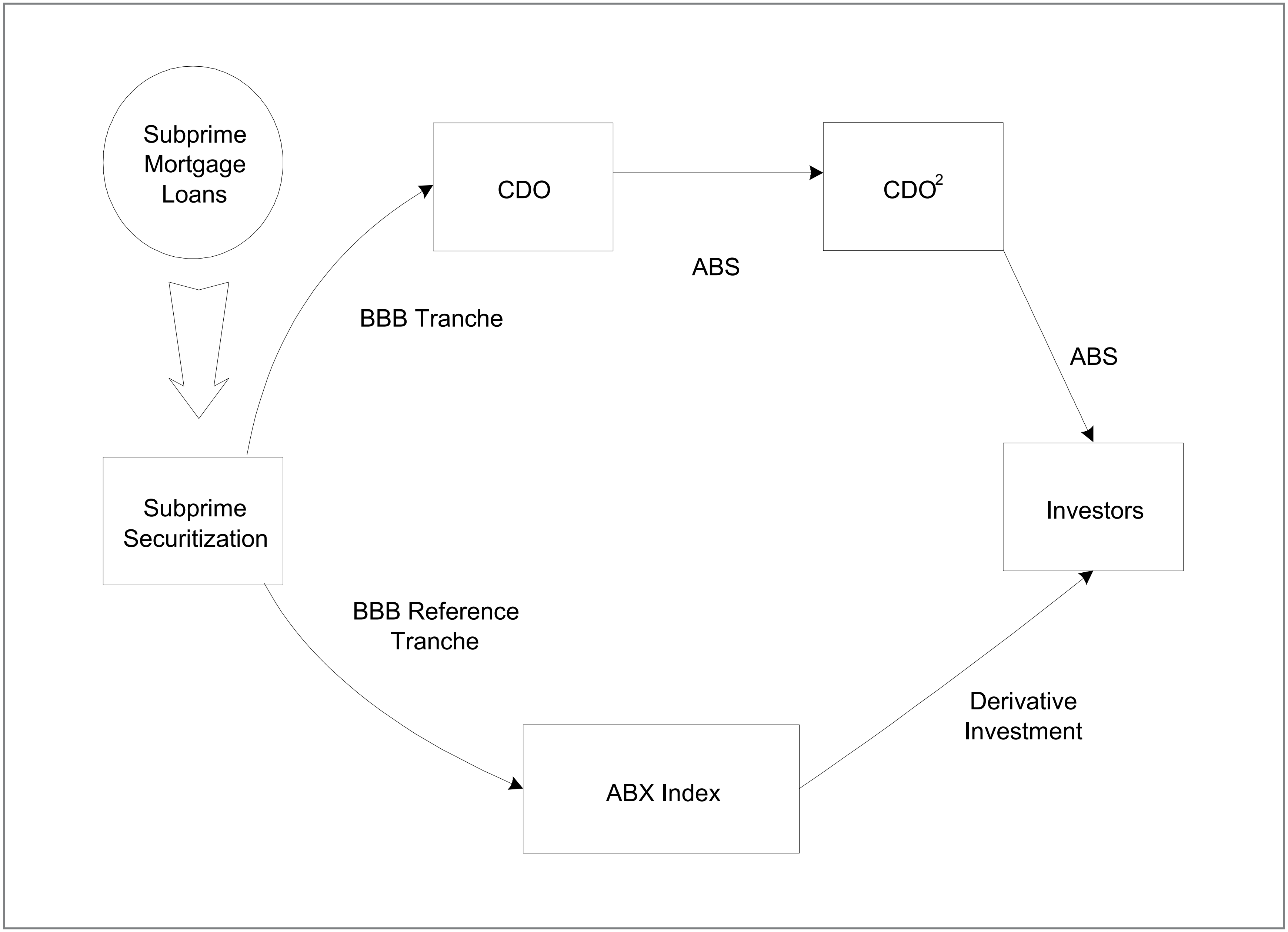
Regulatory Hotspots

- Higher cost loans extended to borrowers who could have qualified for lower cost loans
- Teaser rates and prepayment penalties
- Loan suitability determined without including tax and insurance escrows in monthly payments

Securitization Balance Sheet

- Assets
  - Present value of pool of subprime mortgage loans

- Liabilities
  - Fully loaded cost of MBS
- Equity
  - Overcollateralization
  - Excess interest


Subprime Mortgage Loans
CDO
CDO^2
ABS
BBB Tranche
ABS
Subprime Securitization
Investors
BBB Reference Tranche
Derivative Investment
ABX Index

Subprime Mortgage Lending

Response by Banking Agencies

- Interagency guidance on nontraditional mortgage product risks (Oct. 2006)
- Statement on Working with Borrowers (April 2007)
  – Encourages prudent workout arrangements with borrowers
- Statement on subprime mortgage lending (June 2007)
  – Underwrite loans to fully indexed rate
  – Require income verification except in certain circumstances
- Statement on loss mitigation strategies for servicers of residential mortgages (Sep. 2007)
  – Joint statement urging *servicers* to help at risk homeowners avoid defaults through loan modifications or restructurings

Congressional Hearings

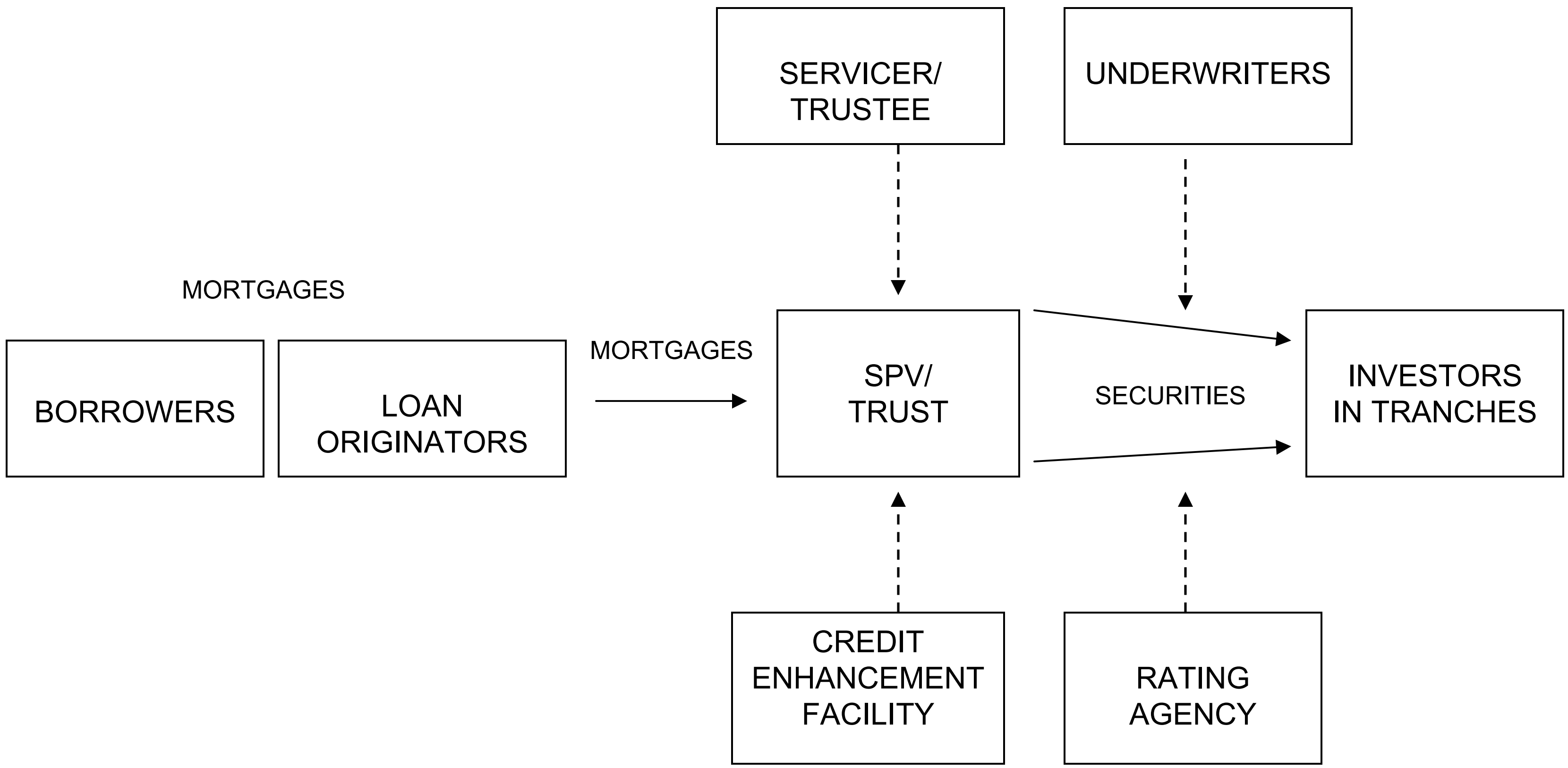
- "Mortgage Market Turmoil: Causes and Consequences," Senate Banking Committee (March 22, 2007)
- "Subprime and Predatory Mortgage Lending: New Regulatory Guidance, Current Market Conditions and Effects on Regulated Financial Institutions," House Financial Services Subcommittee on Financial Institutions and Consumer Credit (March 27, 2007)
- "Possible Responses to Rising Mortgage Foreclosures," House Financial Services Committee (April 17, 2007)
- "Subprime Mortgage Market Turmoil: Examining the Role of Securitization," Subcommittee on Securities, Insurance and Investment of the Senate Banking Committee (April 17, 2007)
- "The Role of the Secondary Market in Subprime Mortgage Lending," House Financial Services Subcommittee on Financial Institutions and Consumer Credit (May 8, 2007)
- "Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy," House Financial Services Committee (Sept. 5, 2007)

Current Legislative Proposals

- H.R. 3915 "The Mortgage Reform and Anti-Predatory Lending Act of 2007" (Rep. Frank)
- S. 1222, the "STOP FRAUD Act" (Sens. Obama and Durbin).
- S. 1299, the "Borrower's Protection Act of 2007" (Sen. Schumer)
- Bankruptcy Code changes
- Sen. Dodd's intended legislation

Subprime Exposure:
Internal Reviews and Due Diligence

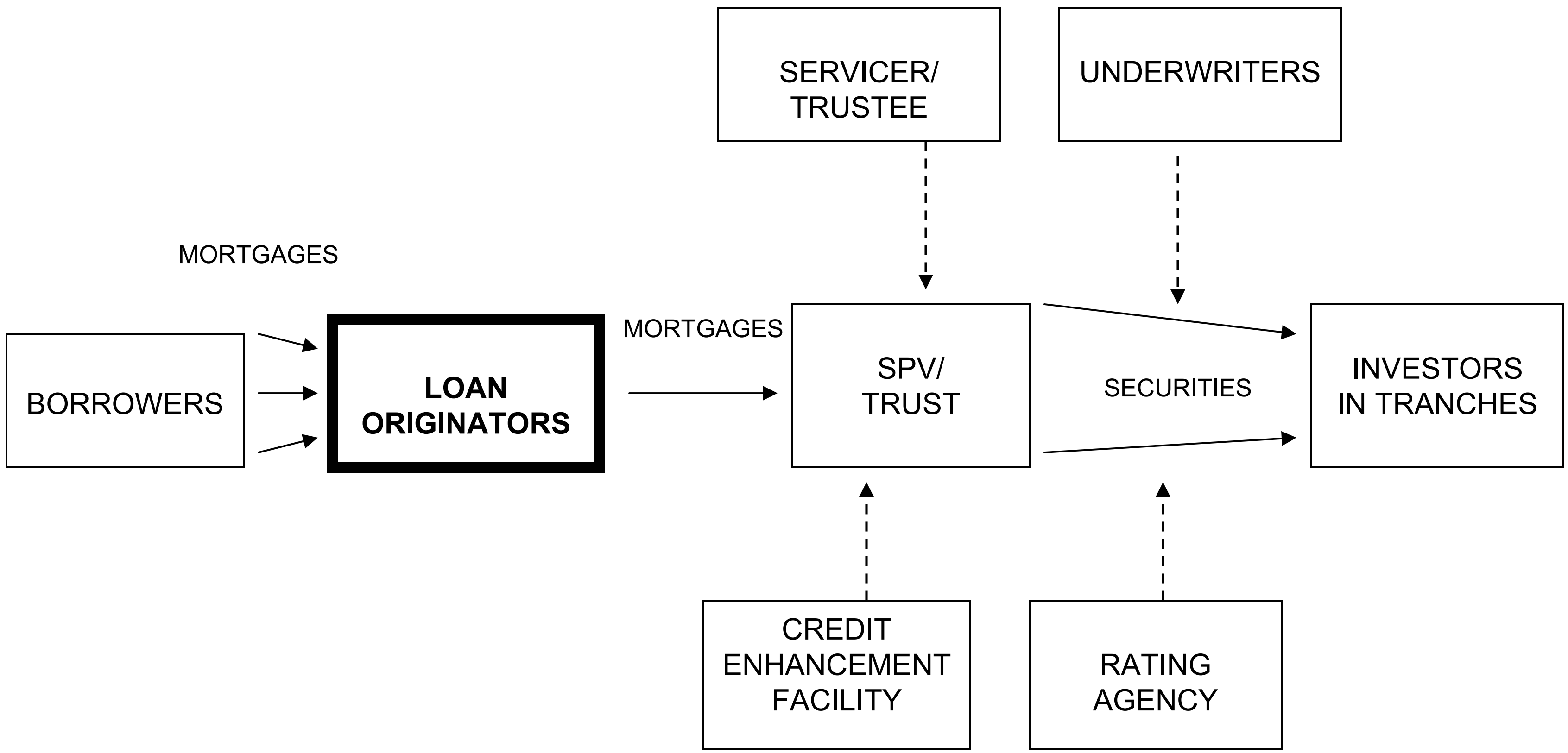
Loan Flow Through Securitization Structure



Overview of Potential Exposure

- We will review the distribution chain in three main parts
  - Loan originators
  - Securitization participants
  - Purchasers: institutional investors/fund managers
- Entities often play multiple roles in this chain

Loan Originators



Loan Originators

- Claims by <u>borrowers</u>:
  - Class actions:
    - Alleging inadequate disclosure of mortgage terms, including of total costs and of the effect of rate resets
    - Alleging discriminatory lending practices
    - Alleging violations of fair business practices statues

Loan Originators

- Claims by <u>purchasers of loans</u>:
  - Contract actions to enforce obligations under repurchase agreements (filed by major financial institutions)

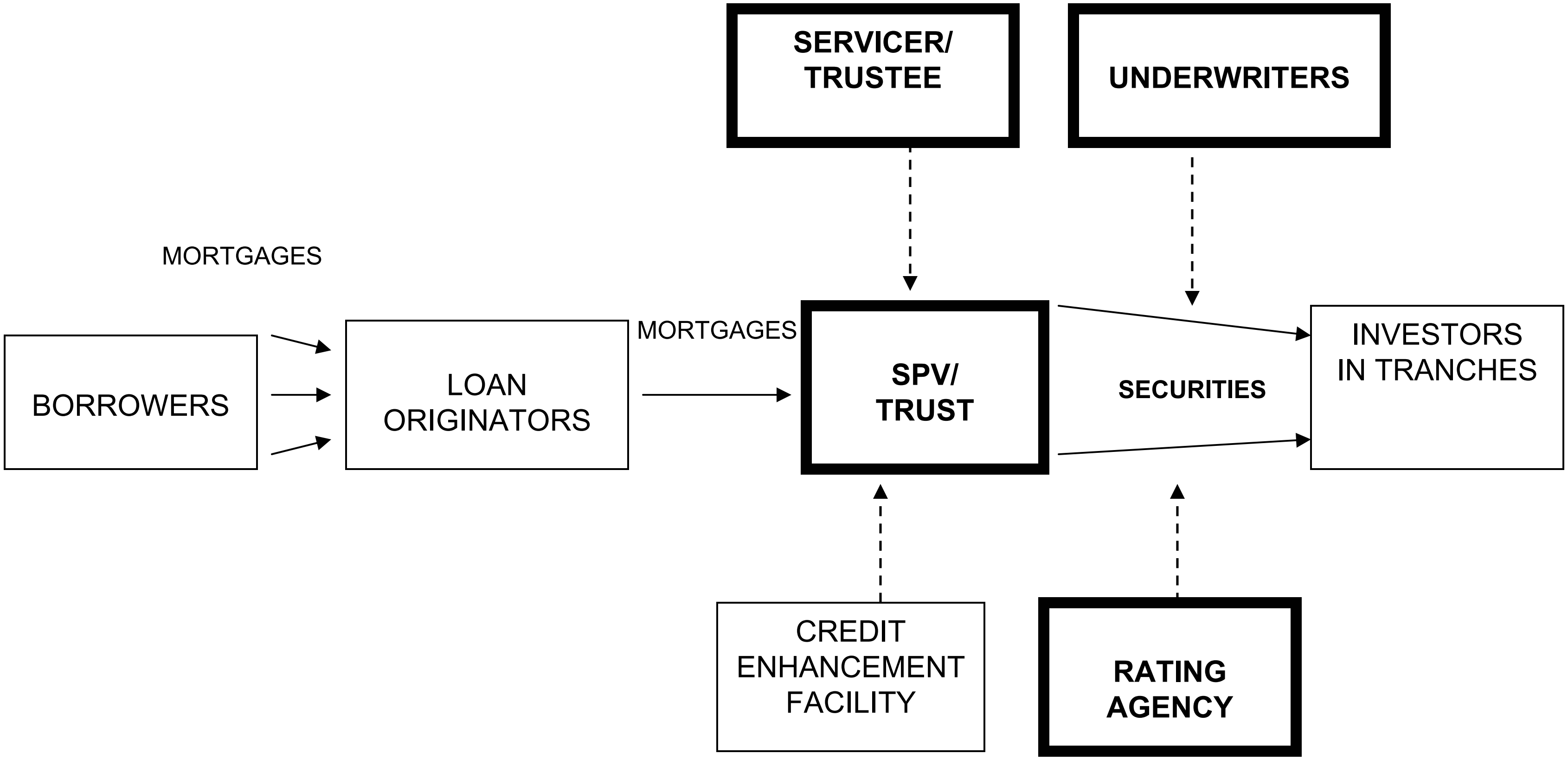
Loan Originators

- Claims by shareholders:
  - Securities claims based on disclosure about:
    - Underwriting standards, quality of loans, sources of loans
    - Ongoing condition of subprime portfolios, *e.g.,* deterioration of loan quality
    - Adequacy of reserves, *e.g.,* for loan repurchase obligations

Actions Against Loan Originators

- State enforcement-agency actions:
  - State Attorneys General
    - Sales practices
      - Includes discriminatory sales practices
    - Appraisal practices
    - Compensation of brokers
    - Rating-agency rankings of mortgage-backed securities
  - Settlements with:
    - Ameriquest Mortgage Company:
      - 48 states. Concealing interest rate and other loan costs. $295 million in restitution.
    - Countrywide Home Loans, Inc.:
      - NY Attorney General. Discriminatory lending practices.

Securitization Partners



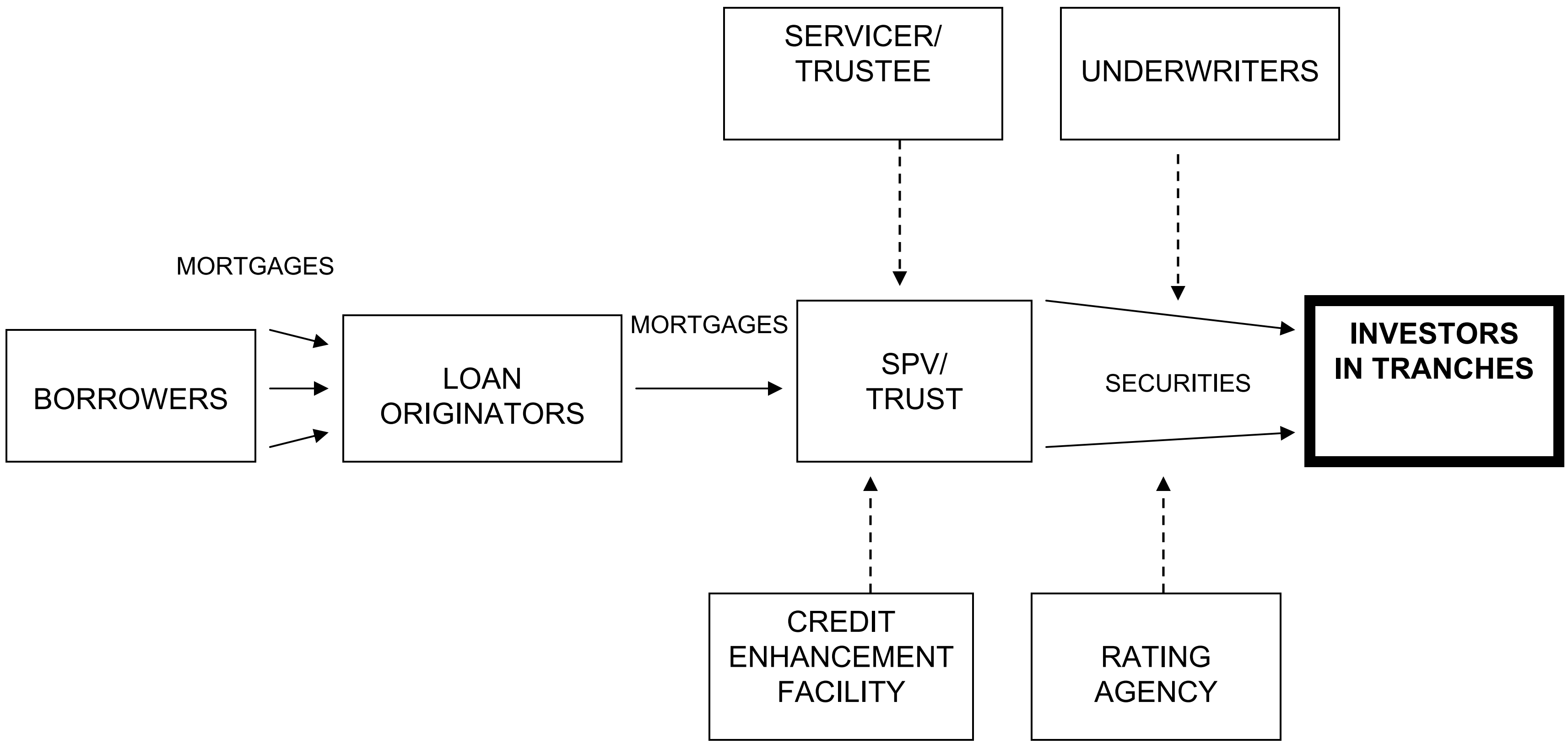
Securitization Participants/Underwriters/Issuers

- Claims by ABS purchasers:
  - Disclosure about initial loan portfolio:
    - Asset pool/Characteristics
    - Underwriting standards/asset quality
    - Source of loans
    - Credit enhancement
  - Ongoing disclosure in periodic reports, *e.g.,* delinquency stats

Securitization Participants/Underwriters/Issuers

- By the SEC:
  - Regulation AB:
    - Disclosures required in offering document and periodic reporting

Securities Purchasers/Fund Managers



Securities Holders/Fund Managers

- Claims by investors:
  - Allegations:
    - Investment decision itself is imprudent or investment is unsuitable
    - Failure to follow standard risk management procedures
    - Insufficient pre-purchase diligence
    - Disclosure to investors

Securities Holders/Fund Managers

- Examples by the SEC:
  - Piper Capital Management (fund manager)
    - Alleged inadequate disclosure about extent of subprime holdings in portfolio and related misrepresentation of investment risks
    - Alleged resulting misstatement of fund's net asset value (NAV)

Emerging Accounting and Disclosure Hot Topics

Emerging Accounting and Disclosure Hot Topics

- Do investors believe there is currently an accounting and disclosure crisis or is it just beginning?
  - We believe its just beginning
  - Disclosures have not kept up with the change in environment
  - The Center for Audit Quality (CAQ) Professional Practice Executive Committee recently published white papers
  - Other topics are emerging or ongoing
    - Adequacy of critical accounting policies, market risk disclosures
    - Complex structured finance activities
    - Adequacy of reserves (including whether companies have created "cookie jar" reserves)

Fair Value

- Severe reduced liquidity in the marketplace has created valuation challenges for accountants
  - Fair value is an essential component of many accounting principles
  - Special attention on maximizing the use of market data. Companies:
    - Should use market data
    - Should not ignore available market data
  - Disclosure of risks and uncertainties already required under GAAP. Examples include:
    - Impact fair value measurements will have on the financial statements
    - Impact of credit/liquidity crisis on use of unobservable inputs

Consolidation of Commercial Paper Conduits

- Re-evaluate the underlying assumptions requires for consolidation analysis of an ABCP conduit
  - Companies should re-evaluate:
    - Previously ascribed low probabilities of occurrence
    - Current involvement to support ABCP conduits
    - Model assumptions ensuring they reflect recent observable market data
    - Assets incorporate market data even if the sponsoring bank believes its own differing assumptions are correct
  - Updating the assumptions at a reconsideration date may change consolidation conclusion for the sponsor

Underwriting and Loan Commitments

- Companies should determine if losses should be recognized for off-market commitments:
  - If the commitment is a derivative, then changes in fair value are reflected in earnings
  - If not a derivative, then
    - For security commitments, analysis of loss recognition based on classification of the underlying security
    - Analysis of loan commitments based on classification of the underlying loan

Adequacy of MD&A

- Critical Accounting Policies, Market Risk Disclosures
  - SEC staff often challenge accounting and disclosure in financial statements based on critical accounting policies
  - Expect focus to be on valuation estimates, reserves, impairments and impact on financing activity
  - Should reflect current environment
    - Should be specific to the company's facts and circumstances
    - Is omission material to investors?
    - What market risks may affect the company and how are they managed?
    - Companies need to be explicit about their polices and the intended effects
    - Describe the company's vulnerability to large swings in risk factors
    - What changes in the environment, or in the company's credit terms, customer profile, or policies or procedures, may affect loss experience?

Complex Structured Financial Transactions

- Interagency release provides broad set of principles for managing the risk associated with complex structured financial transactions (CSFT)
  - Released in January 2007
  - Scope: Any transaction that may create heightened legal or reputation risks
  - Beware of situations:
    - Securitize assets via an SPE in order to change the classification of the underlying security
    - Enron like SPE structures set up to off-load positions that have declined in value
      - Involve circular transfer of risk that lack economic substance or business purpose
      - Lack economic substance or business purpose
      - Involve oral or undocumented agreements
      - Have material economic terms that are inconsistent with market norms

Loan Loss Reserves

- Are the reserves adequate or have companies created “cookie jar” reserves?
  - SEC staff will not accept aggressive or overly conservative valuations.
  - No safety in numbers, SEC staff will still pursue restatement if a company did not follow GAAP.
  - Procedural discipline required by FRR 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*
  - Beware of situations:
    - Failure to identify and provide adequately for probable loss
    - Unacceptable methods used to establish reserve
    - False and misleading press releases
    - Increases or reductions of the reserves that do not tie to underlying methodology or reflect general business risks
    - Poor internal accounting controls
    - Financial reporting NOT consistent with the information internally presented reports
    - Loss factors NOT adjusted on a timely basis for current conditions

Questions?

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