January 12, 2009



Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board

director@fasb.org

File Reference: Proposed FSP FAS 107-a

This letter is in response to the Invitation to Comment on the above-referenced matter.

By way of background I have been a security analyst following financial companies for 35 years, so this letter can be classified as a user comment. The opinions in this letter are my own and not necessarily those of Fox-Pitt Kelton Cochran Caronia Waller.

Overview

As a user I have long believed that fair value is the most appropriate measure for financial instruments. The financial liquidity crisis of 2007-2008 has placed strains on the global financial system and has led to a rethinking of various aspects of accounting particularly as they apply to fair value and this, in turn, has led to the need for more disclosures by reporting entities.

I believe that this FSP will prove to be the most important of all the short term statements and position papers to be issued by either the FASB or the SEC during the current financial crisis. Requiring institutions to calculate and disclose the fair value of loans gets directly to the heart of investor concerns regarding lending institutions, while at the same time, requiring disclosures of the incurred loss value of securities will give evidence of the extent to which liquidity discounts and other trading factors are affecting the values of securities. Both of these are extremely useful for investors.

Question 1

I believe requiring disclosures of assets under different reporting measurement attributes will prove to be extremely useful information for investors since external estimates of this data are at the core of all valuations of financial stocks.

This information will also allow investors to better compare companies to each other and to better understand equity valuations.

Question 2

I do not believe assets measured at fair value with changes recognized through earnings need be included in these disclosures.

Questions 3-4

While information for asset values constitutes the most important component of the proposed requirements, information about the income statement effects of the different bases is also useful.

While requiring income from continuing operations before tax would be helpful, it would be more useful to users to show the after tax effect of the different bases as well as the resulting shareholders' equity. As a practical matter, if this information is not required, investors will use whatever data is available to estimate both the after-tax income and (more importantly) the shareholders' equity. As evidence of this point I attach a recent research report I published showing how I expect the newly disclosed information will be used by investors.

Reconciliations of reported income to the pro forma figures on the adjusted bases would also be useful.

Question 5

It is imperative that this data be required as soon as possible.

Since in order to show the income effect in the proposed disclosures, companies will need to have opening balances, I suggest this information to also be disclosed.

Question 6

The operational question is better left to preparers.

As a practical matter I would expect reporting entities to have some reservations about the magnitude of the requirements in a short period. As a cost-benefit analysis the Board might consider only requiring this information from financial institutions where there is the greatest sense of urgency.

On a related issue, I applaud the FASB's decision to join with the IASB to address the issue of complexity in accounting and reporting for financial

instruments. In the long run many of the operational problems with financial instrument reporting (specifically impairments) could be resolved by having all financial instruments recorded at fair value. This would also eliminate the inconsistencies resulting from having some changes in value reported through the income statement and some through equity.

I would be pleased to discuss this matter further at your convenience.

Alan Zimmermann

Accounting Perspectives

Analyst(s): Alan Zimmermann

Alan.Zimmermann@fpk.com

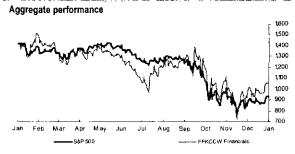
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Expanded Disclosures; Useful Information

- The FASB has issued an Exposure Draft to require expanded disclosures about the value of financial instruments. Reporting entities would be required to disclose the "fair value" and the "incurred loss" value of loans, held-to-maturity securities and available-for-sale securities. The disclosures will be required for yearend 2008 reporting.
- We believe investors will find the information to be extremely useful. The data will allow investors to better see the impact that the current financial crisis has had on financial institution balance sheets and income statements. This will be helpful in comparing companies and for understanding valuations.
- This report discusses the proposed requirements and creates hypothetical sample companies to study the impact of the disclosures on various financial sectors.
- In anticipating the disclosures one should presume that the fair value of loans will be below
 the reported values which are on an incurred loss basis, while the incurred loss value of
 securities will be above the reported fair value. Hence the impact on any company will depend
 on the relationship of loans and securities in its portfolio.
- In our sample models regional banks have the largest declines in fair value shareholders' equity. This is because of the higher concentration of loans in their portfolios.
- Life insurers are expected to show the largest increase in incurred loss shareholders' equity. This is because of their heavy concentration of investment securities.

	1W	1M	3 M	YTD
S&P 500	4.1	5.9	-12.2	2.7
FPKCCW Financials	4.9	8.3	-9.7	1.7
Rel. FPKCCW Financials	-0.8	-2.3	-2.9	1.0

Source: FactSet prices



Source: FactSet prices

Analyst certifications and required disclosures begin on page 10.

Fox-Pitt Kelton Cochran Caronia Waller on the Web: http://www.fpk.com/x/publicresearchdisclosure.html

New York Tel: +1 212 687 1105 Chicago Tel: +1 312 425 9335 Hartford Tel: +1 860 380 2000 London Tel: +44 (0) 20 7663 6000 Hong Kong Tel: +852 3191 8588



Expanded Disclosures; Useful Information

As part of an effort to make corporate reporting more transparent in the midst of the current financial crisis the Financial Accounting Standards Board has issued an Exposure Draft to amend FAS 107, Disclosures about Fair Value of Financial Instruments, that will require all reporting entities to disclose the fair value and the incurred loss value of their securities and loan portfolios. While the disclosures will be required for all reporting entities they are most applicable to financial institutions.

With this information, investors will be able to calculate book values and earnings on both the fair value and incurred loss bases and compare this data both to reported book value and current valuations. This will allow investors to more clearly see the impact the financial crisis has had on the financial condition of institutions.

We believe this will prove to be extremely useful information for investors.

Given the FASB's accelerated timetable these disclosures will be included in 2008 Form 10-K filings. As usual with the Exposure Draft process there may be some changes between the proposal and the final requirements.

The International Accounting Standards Board has proposed a similar amendment to IFRS 7, Financial Instruments: Disclosures, so the eventual provisions will be effective globally, not just in the US.

The Disclosures will Show Different Impacts on Various Types of Institutions.

To study the potential impact of the forthcoming disclosures on various types of institutions we created four hypothetical examples; a regional bank, a money center bank, a life insurer and a property-casualty insurer.

For our examples we have presumed fair values will be lower than incurred loss values for loan portfolios and that incurred loss values for securities portfolios will be above fair value. This means that the disclosures will show different impacts on the various types of financial institutions because they have different balance sheet compositions.

As a generalization, regional banks will show the largest fair value decline among the sectors because of the lower value of the loan portfolios. Life insurers are expected to show the biggest increase in incurred loss values because of their large securities portfolios. Money center banks will probably not show significant declines to fair book value because much of their investment portfolios are classified as trading securities and, thus, carried at fair value with the change in value through the income statement. Property-casualty insurers generally don't have loan portfolios so there are no expected marks to fair value.

These conclusions are discussed in more detail in a later section of this report.



New Requirements

Under current accounting principles, financial statements are presented on a mixedattribute basis. That is, assets (and liabilities) with related economic characteristics are reported using different measurement attributes. The goal of the expanded disclosures is to show various assets under alternative bases.

The expanded disclosures will be required for;

- Held-to-maturity debt
- Available-for-sale debt, and
- · Loans and receivables

The new requirements do not apply to any debt securities or loans or leases that are carried at fair value with changes in fair value recognized through the income statement. This means securities classified as trading are not included as well as certain loans, particularly those held for sale.

For the three types of assets, reporting entities will have to show (in tabular form):

- Carrying value (i.e. as reported)
- Fair value
- Incurred loss amount.

The incurred loss amount is the present value of the future cash flows discounted at the effective interest rate of the contract. This could be referred to by other names, such as economic value.

In addition to the balance sheet data, reporting entities will be required to show pretax income on the same three bases, reported, fair value and incurred loss. It is possible that this requirement could be modified in the final statement to require companies to disclose net income and shareholders' equity on the three bases. This, in our opinion, would be more useful to investors. If shareholders' equity and net income are not ultimately required, the amounts can be approximated from the pretax income figures.

Similar Economics; Different Reporting Bases

Under current accounting, different types of assets are reported using differing measurement attributes even though they have similar economic characteristics. For example, loans are carried on an incurred loss basis meaning at amortized cost with a loan loss provision. Debt securities are measured differently whether they are classified as trading, held-to-maturity or available-for sale. HTM securities are carried at amortized cost (adjusted for impairments) while AFS and trading securities are carried at fair value.

The purpose of the proposed disclosures is to show these assets on alternative bases from those used in the reported financial statements.

Fair value loans will be below incurred loss amounts

For the most part, loans are recorded at amortized cost with a provision for a loan loss provision. The determination of the loan loss provision is largely governed by FAS 114 and FAS 5 which require that the provision be established on an "incurred loss" basis. This means expected losses through the reporting date which is different from the losses expected over the life of the loan.

The fair value of loans, like any financial instrument, is determined by FAS 157 which defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants." This means that fair value is an exit price.



Since there is generally no orderly market for loans these can be thought of as Level 3 assets in the FAS 157 classification hierarchy. That is, they are assets for which there are no observable market inputs so managements can value the assets based on their assumptions about what valuation parameters market participants would use. This is generally referred to as "mark to model."

As discussed below, in our hypothetical examples we assume that the fair value of a loan portfolio will be below the current carrying value although the extent of the difference will vary by the mix of each bank's portfolio.

The Incurred Loss Amount of Debt is above Fair Value

For most debt categories the fair value has been negatively affected by expanded spreads during this financial crisis. Yet, for many securities the underlying cash flows have not been affected (too much) by the state of the economy. This factor means that the incurred loss amounts, that is, the present value of the future cash flows will, for most securities, be above fair value.

Figure 1 shows a summary of how we see valuation differences of the various instruments with different measurement bases.

Figure 1
Expanded Valuation Disclosures
(Proposed FSP FAS 107-a)

Balance Sheet	Carrying <u>Value</u>	Fair <u>Value</u>	Incurred Loss
Held-to-maturity debt securities	Amortized Cost	Lower	Higher
Available-for-sale debt securities	Fair Value	Same	Higher
Loans and lease receivables	Incurred Loss	Lower	Same
Total		Lower	Higher

Source: FPKCCW

Considering that most financial institutions have only a minimal amount classified as held-to-maturity the most significant changes will be the incurred loss value of the available for sale securities and the fair value of the loans.

Hypothetical Examples Demonstrate the Impact on Various Types of Institutions

To understand how book values would look under the different bases we have created sample companies in four sectors, regional banks, money center banks, life insurance and, property-casualty insurance. The results are shown in Figures 2-5.

In developing these examples, we made two assumptions: 1) that the fair value of loans would be equal to 93% of the carrying value and 2) that the incurred loss value of debt would be 113% of fair value. Of course these numbers will vary based on the



composition of each individual company's portfolios but these seem valid generalizations for our examples.

The 7% discount figure for loans is based on research from our bank analysts showing that their estimate of the life of loan losses would be 7% of the gross loans. In the absence of observable market transactions that seems like a reasonable starting point for determining the fair value of loans.

The 13% increase in the debt portfolios largely reflects the fact that the decline in the fair value of the securities has been driven largely by widening spreads which do not affect the incurred loss amounts.

In reviewing how these expected disclosures affected the different types of entities we noted the following:

- The fair value shareholders' equity of the regional banks would be the most negatively impacted of the various sectors because these banks have a high ratio of loans to securities and high leverage ratios. Leverage, in this case, is the sum of the debt and loans to equity.
- Money center banks would not have as big a drop in fair value book versus
 reported book because a large portion of their investment portfolios are
 classified as trading and, therefore, already carried at fair value with the
 change in value reported through the income statement.
- Life insurance companies would have the largest increase to incurred loss book value because of their high concentration in debt instruments and high level of leverage.
- Property-casualty insurers, for the most part, do not have loans in their portfolios so all we see is the increase in incurred loss values. The size of the impact, though, is tempered by the low leverage ratio.
- We have not included any of the traditional investment banks in these examples because almost all of their assets are trading securities and, hence, not included in the scope of the proposed disclosures.



Figure 2
Expanded Valuation Disclosures
Regional Bank Example
(Proposed FSP FAS 107-a)

(Proposed FSP FAS 107-a)	0 1	F-lu	Incurred
Balance Sheet	Carrying <u>Value</u>	Fair <u>Value</u>	Loss <u>Amount</u>
Held-to-maturity debt securities	100	90	105
Available-for-sale debt securities Percent of carrying value	8,000	8,000	9,040 113%
Loans and lease receivables Percent of carrying value	47,000 [43,710 93%	47,000
Total Percent of carrying value	55,100	51,800 94%	56,145 102%
Shareholders' equity Ratio of debt securities and loans to equity Fair value adjustment	6,000 918%	6,000	6,000
Pretax		-3,300	1,045
Tax @ 35%		1,155	-366
Aftertax adjustment		-2,145	679
Fair value or incurred loss equity		3,855	6,679
Percentage change		-36%	11%



Figure 3
Expanded Valuation Disclosures
Money Center Bank Example
(Proposed FSP FAS 107-a)

(Proposed FSP FAS 107-a)			Incurred
Balance Sheet	Carrying <u>Value</u>	Fair <u>Value</u>	Loss <u>Amount</u>
Held-to-maturity debt securities	0	0	0
Available-for-sale debt securities Percent of carrying value	100,000	100,000 [113,000 113%
Loans and lease receivables Percent of carrying value	500,000 [465,000 93%	500,000
Total Percent of carrying value	600,000 [565,000 94%	613,000 102%
Shareholders' equity Ratio of debt securities and loans to equity Fair value adjustment	125,000 480%	125,000	125,000
Pretax		-35,000	13,000
Tax @ 35%		12,250	-4,550
Aftertax adjustment		-22,750	8,450
Fair value or incurred loss equity	[102,250	133,450
Percentage change		-18%	7%



Figure 4
Expanded Valuation Disclosures
Life Insurance Example
(Proposed FSP FAS 107-a)

Life Insurance Example (Proposed FSP FAS 107-a)			Incurred
Balance Sheet	Carrying <u>Value</u>	Fair <u>Value</u>	Loss <u>Amount</u>
Held-to-maturity debt securities	3,500	3,000	4,000
Available-for-sale debt securities Percent of carrying value	162,000	162,000 [183,060 113%
Loans and lease receivables Percent of carrying value	40,000 [37,200 93%	40,000
Total Percent of carrying value	205,500	202,200 98%]	227,060 110%
Shareholders' equity Ratio of debt securities and loans to equity Fair value adjustment	23,000 893%	23,000	23,000
Pretax		-3,300	21,560
Tax @ 35%		1,155	-7,546
Aftertax adjustment		-2,145	14,0 1 4
Fair value or incurred loss equity		20,855	37,014
Percentage change		-9%	61%



Figure 5
Expanded Valuation Disclosures
Property-Casualty Example
(Proposed FSP FAS 107-a)

(Proposed FSP FAS 107-a)	Carrying	Fair	Incurred Loss
Balance Sheet	Value	<u>Value</u>	<u>Amount</u>
Held-to-maturity debt securities	0	0	0
Available-for-sale debt securities Percent of carrying value	33,000	33,000 _	37,290 113%
Loans and lease receivables Percent of carrying value	°E	0	0
Total Percent of carrying value	33,000]	33,000 100%	37,290 113 <u>%</u>
Shareholders' equity Ratio of debt securities and loans to equity Fair value adjustment	13,000 254%	13,000	13,000
Pretax		0	4,290
Tax @ 35%		0	-1,502
Aftertax adjustment		0	2,789
Fair value or incurred loss equity		13,000	15,789
Percentage change		0%	21%



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Cioba: Tempany taning activitions		
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Underperform (UP)	We expect the stock to underperform its sector over the next 12 months	
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Global sector ranking definitions

Overweight (OW)	We expect the sector to outperform the relevant market index over the next 12 months
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Fox-Pitt Kelton Cochran Caronia Waller

US FINANCIALS

Adam Klauber, US Director of Research &

+1 312 425 4087 adam.klauber@fpk.com

US Asset Managers/US Financial Technology

Roger Smith, Head of US Asset +1 212 857 6116 roger.smith@fpk.com Managers/Financial Technology Campbell Anthony +1 212 857 6132 campbell.anthonv@fpk.co William Broomail +1 212 857 6139 william.broomall@fpk.com

US BANKS/TRUST BANKS

David Trone, Head of US Commercial +1 212 857 6151 david.trone@fpk.com and Investment Banks Research +1 212 857 6137 andrew.marquardt@fpk.co Andrew Marguardt Albert Savastano, CFA CPA +1 212 857 6146 albert.savastano@fpk.com +1 212 857 6147 thomas.alonso@fpk.com Thomas Alonso, CFA +1 212 857 6165 jonathan.elmi@fpk.com Jonathan Elmi, CPA +1 212 857 6136 doug.johnson@fpk.com Doug Johnson Bill Young, CFA +1 212 857 6152 bill.young@fpk.com

US FINANCIAL GUARANTORS

Gary Ransom, Head of US Financial +1 860 380 2001 gary.ransom@fpk.com Guarantors Research Amit Kumar

+1 212 857 6113 amit.kumar@fpk.com

US FINANCIAL STRATEGIES

Adam Klauber +1 312 425 4087 adam.klauber@fpk.com Hitomi Asada, CFA +1 212 857 6140 hitomi.asada@fpk.com

US HOMEBUILDERS

+1 212 857 6168 robert.stevenson@fpk.com Robert Stevenson

US INVESTMENT BANKS & BROKERS

David Trone, Head of US Commercial +1 212 857 6151 david.trone@fpk.com and Investment Banks Research Ivy De Dianous, CFA +1 212 857 6131 ivy.cao@fpk.com +1 212 857 6149 steven.fu@fpk.com

US LIFE INSURANCE

Mark Finkelstein, Head of US +1 312 425 4079 mark.finkelstein@fpk.com Life Insurance Paul Sarran +1 312 425 4737 paul.sarran@fpk.com

US MARKET STRUCTURE

Edward Ditmire, CFA +1 212 857 6176 edward.ditmire@fpk.com Chris Ross, CPA +1 212 857 6203 chris.ross@fpk.com

US MORTGAGE & SPECIALTY FINANCE

Bill Carcache, CFA,CPA +1 212 857 6134 bill.carcache@fpk.com Stephanie Efron +1 212 857 6138 stephanie.efron@fpk.com +1 212 857 6163 matt.howlett@fpk.com Matthew Howlett

US MORTGAGE REITS

Caroline Steers

Matthew Howlett +1 212 857 6163 matt.howlett@fpk.com

US PROPERTY CASUALTY INSURANCE

Gary Ransom, Co-Head of US Property +1 860 380 2001 gary.ransom@fpk.com Casualty Insurance Research William Yankus, Co-Head of US Property +1 860 380 2003 william.yankus@fpk.com Casualty Insurance Research Matthew J. Carletti +1 312 425 4734 matthew.carletti@fpk.com Dan Farrell +1 212 857 6144 dan.farrell@fpk.com Amit Kumar +1 212 857 6113 amit.kumar@fpk.com +1 312 425 4082 dan.schlemmer@fpk.com Dan Schlemmer

EUROPEAN FINANCIALS

EUROPEAN BANKS

David Williams, Head of +44 20 7663 6049 david.williams@fpk.com European Banks Research +44 20 7663 6063 benile,creelan-sandford@fpk,com Benjie Creelan-Sandford +44 20 7663 6041 geoff.dawes@fpk.com Geoff Dawes, CEA +44 20 7663 6043 geoffrey.elliott@fpk.com Geoffrey Elliott +44 20 7663 6054 jagoba.garcia@fpk.com Jagoba Garcia, CFA +44 20 7663 6048 leigh.goodwin@fpk.com Leigh Goodwin Oleg Konstantinov +44 20 7663 6065 oleg.konstantinov@fpk.com +44 20 7663 6019 chris.roberts@fpk.com Chris Roberts Alessandro Roccati +44 20 7663 6055 alessandro.roccati@fpk.com Jonathan Tyce +44 20 7663 6058 jonathan.tyce@fpk.com +44 20 7663 6095 pawel.uszko@fpk.com Pawel Uszko

EUROPEAN INSURANCE

Raghu Hariharan, Head of European Insurance Research +44 20 7663 6047 raghu.hariharan@fpk.com +44 20 7073 2360 michael.broom@fpk.com Michael Broom +44 20 7073 2330 hamish.chalmers@fpk.com Hamish Chalmers +44 20 7663 6064 hadley.cohen@fpk.com Hadley Cohen +44 20 7663 6040 jonathan.lawlor@fpk.com Jonathan Lawlor +44 20 7663 6057 farquhar.murray@fpk.com Farouhar Murray +44 20 7073 2365 william.hardcastle@fpk.com Will Hardcastle

EUROPEAN GENERAL FINANCIALS

Neil Welch, Head of General +44 20 7663 6061 neil.welch@fpk.com Financials Research +44 20 7663 6053 william.howlett@fpk.com Will Howlett Andrew Mitchell +44 20 7663 6052 andrew.mitchell@fpk.com

GLOBAL FINANCIALS

Robin Evans, Global Strategist +44 20 7663 6045 robin.evans@fpk.com

ASIA PACIFIC

Asian Banks (Ex-Japan)

Jim Antos, Head of Asian +852 3191 8630 irm.antos@fpk.com Banks Research +852 3191 8619 brian.hunsaker@fpk.com Brian Hunsaker Warren Blight +852 3191 8611 warren.blight@fpk.com Dan Dan Zhu +852 3191 8623 dandan.zhu@fpk.com

ASIAN INSURANCE (EX-JAPAN)

Kenneth Yue +852 3191 8610 kenneth.yue@fpk.com

ASIAN GENERAL FINANCIALS (EX-JAPAN)

+852 3191 8625 sam.hilton@fpk.com Sam Hilton

JAPANESE RESEARCH

David Threadgold, CFA, Head +81 3 6739 1301 david.threadgold@fpk.com of Japanese Research Yuki Allyson Honjo +81 3 6739 1302 yuki.honjo@fpk.com Jun Oishi +81 3 6739 1303 jun.oishi@fpk.com

UNITED STATES

420 Fifth Ave One South Wacker Drive 5th Floor New York, NY 10018 Suite 2700 Chicago, IL 60606 Tel: +1 312 425 9335 Fax: +1 312 425 9256 el; +1 212 687 1105 Fax: +1 212 599 2723

970 Farmington Avenue Suite 205
West Hartford, CT 06107
Tel: +1 860 380 2000
Fax: +1 860 380 2027

+1 212 857 6148 caroline.steers@fpk.com

UNITED KINGDOM 5th Floor

25 Copthall Avenue London, EC2R 7BP Tel: +44 20 7663 6000 Fax: +44 20 7071 7700

3108, 31/F Central Plaza Moto-Akasaka MI Building 4F 18 Harbour Road Wan Chai, Hong Kong Fax: +852 3191 8988

1-3-26 Moto-Akasaka Minato-ku, Tokyo 107-0051 Tel: +81 3 6739 1305 Fax: +81 3 6739 1310

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