WESTWOOD CAPITAL, LLC

OPINION

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Inauguration, Aggregation and Aggravation

On the occasion of President Obama's inauguration, we are publishing pieces on the two elements of the economy that we believe require the most urgent attention by the incoming administration – the unemployment crisis and, in this report, repair of the banking system.

Highlights

- In the days preceding the new administration's White House occupancy, several reports from the Treasury, Federal Reserve and FDIC cited the need to change the direction of bank rescue policies yet again.
- Nevertheless, we have reports of the resumption of consideration of troubled asset purchase strategies, previously considered and rejected during the Bush administration. Troubled assets? It's as though we had the worst luck in some financial-genetic draw—a group of irascible, miscreant children in need of loving discipline. Toxic? Poisonous, yes, but not some unfortunate oil spill destroying pristine coastline or hobbling innocent birds.
- It is the banking institutions that have proven to be troubled and toxic, and the must be recapitalized and helped to fulfill their primary function in a manner that is fair and equitable to taxpayers.
- We don't understand anyone's reluctance, other than dyed-in-the- wool, scorched-earth ideologues, to have the banks start over with new capital—at first, the government's, but in short time private capital, in lieu of taxpayers overpaying for assets at a price sufficient to support existing bank capitalization based on smoke, mirrors and overstated asset values.
- We don't buy into the notion that if the government owns too much of the banks, the banks won't be able to attract private-sector investment.
- Moreover, we remain concerned that with our zombie banks and overstated bank assets, we more resemble Japan in the 1990s than the United States anywhere near its best.
- In this report, we present a workable, common sense solution to the recapitalization, initially by the government, of the country's systemically critical banks, that clears the way for a resumption of normal banking functions and for future private investment in the banks.

Overview

This week's inauguration of President Barack Obama marks the commencement of perhaps the most expectation-laden first 100 days in the Oval Office since that time frame was used to measure FDR's performance in 1933. In the days preceding the new administration's White House occupancy, several reports from the Treasury, Federal Reserve and FDIC cited the need to change the direction of bank rescue policies yet again. It is painfully apparent that the dozen or so initiatives developed during the waning days of Bush II have not met the challenges posed by a global financial and economic crisis, the likes of which haven't been seen since Roosevelt was in office.

Nonetheless, the continuing Fed and FDIC chairs, Ben Bernanke and Sheila Bair, respectively, have been joined by several new Obama appointees (most importantly, former Treasury Secretary Lawrence Summers, the incoming Director of the President's National Economic Council) interested in attacking the banking-sector elements of the global financial crisis by buying "at fair value[1]" bubble-era assets to remove them from the banking system and aggregate them into a government funded "bad bank" for future disposal. Sounds an awful lot like what former Treasury Secretary Henry Paulson was espousing, and ultimately abandoned, back when the $700 billion TARP fund was established under the Emergency Economic Stabilization Act (which will now likely be referred to as EESA 1, given the additional legislation that's sure to follow).

The scheme du jour again focuses on our banking institutions' "troubled" or "toxic" assets, rather than on the institutions themselves. Troubled assets? It's as though we had the worst luck in some financial-genetic draw—a group of irascible, miscreant children in need of loving discipline. Toxic? Poisonous, yes, but not some unfortunate oil spill destroying pristine coastline or hobbling innocent birds.

The Root Cause

At the root of our global economic crisis are not troubled or toxic assets that have appeared by virtue of happenstance, victimizing unlucky financial institutions. Rather, the developed nations have bequeathed on the globe troubled and toxic financial behemoths, wannabe financial behemoths, their managements and, yes, their go-along-blindly shareholders, all of which have massively poisoned the economic well and remain mired in endless self-created sludge.

Treating the sludge they've generated—at an ultimate cost to governments worldwide of some $5 trillion, if we are lucky (to say nothing of multiple trillions more in equity lost by homeowners and other investors who often enthusiastically participated in this decade's orgy of debt-induced asset inflation)—without addressing the sins of the "systemically critical" corporate fathers of the "troubled" garbage should be anathema to all involved in economic policy responses to the present crisis.

Yet now, after the swearing-in of a new administration dedicated to saving us and restoring economic prudence, we are seeing the rehashing of previously rejected ideas oriented around Bush administration

[1] Note that "fair value" is meant by Chairman Bair to be something other than "market value," as the banks have been either unwilling to part with their assets at market value, or there is no market for some of them. It's high time to abandon this sort of rhetoric and speak plainly. Whenever we hear any branch of our government speaking of buying assets at "fair value," somewhere a polygraph needle is bending and about to break.

failed ideology. Rather than ensuring the banks are restructured in the best interests of taxpayers and the general economy, we are again witnessing the former administration's bias toward the interests of bank shareholders and other stakeholders, coupled with their aversion to government ownership of any significant portion of the banking system. (It is now clear, to any keen observer, that Paulson's promises to Congress to obtain equity interests in the banks rescued by Treasury was just lip service, given the teaspoonful of warrants Treasury has demanded to date.)

Please Excuse our Temerity

So, at the risk of failing their class, those of us passing notes in the back of the lecture hall are prepared to raise our hands and ask (former) Professors Summers, Bernanke and Bair, "What the heck is your problem with wiping out the economic interests of existing common shareholders of toxic and currently systemically worthless (albeit critical) banks?" We don't understand anyone's reluctance, other than dyed-in-the- wool, scorched-earth ideologues, to have the banks start over with new capital—at first, the government's, but in short time private capital, in lieu of taxpayers overpaying for assets at a price sufficient to support existing bank capitalization based on smoke, mirrors and overstated asset values. And here's the real puzzle, Professors: None of you has a record indicating a profoundly ideological bent. What's up with that?

Nope, we didn't miss your lecture when you posited that if the government owns too much of the banks, the banks won't be able to attract private-sector investment. With all due respect, guys and gal, that's hogwash!

What potential investor truly cares about who owns the common equity of banks *before* they invest (other than to make sure they aren't getting into bed with unsavory elements)? Other than price, all they should care about is not getting significantly diluted after they invest and the risk that insolvency will wipe out their entire stake (a risk presently faced by shareholders of nearly every large bank; hence, the share prices thereof).

Now, those of us in the back rows of the lecture hall are not that smart; we'll leave the smart designation to Nobel Prize winner Paul Krugman, who wrote of similar bewilderment on this subject in Monday's *New York Times*. But it seems abundantly clear to us that there is a far better solution to restructuring the troubled and toxic banks than overpaying for assets no one wants to buy at present—the ultimate value of which is in substantial doubt. And if we are going to dedicate our grandchildren's money to resolving the banking crisis, let's at least get them the economic upside in trade.

Grabbing the Bull by the Horns

The solution, as we see it, should follow these lines:

- First, instead of worrying that tougher regulatory standards will render more systemically critical banking institutions insolvent, the FDIC and OCC must ramp up their inspectors' tough love to a level that causes banks to start marking their assets to market where possible, but certainly to the value of collateral securing many loans. Waiting around for a market bid to prove the value of a given loan, CDO or other derivatives in an illiquid

market is really chasing your own tail, and it allows the banks to manipulate marks by simply not putting certain assets out for indicative bids. By the time sufficient liquidity emerges to allow the market to render a verdict, deteriorating collateral values will have spoken louder. The present application of "mark to model" accounting for illiquid assets are only as good as the inputs used, and it is apparent that in 2008 banks were using some pretty rosy assumptions given the quarter-after-quarter successive write-downs.

- Instead of cutting bailout deals with institutions on an ad hoc basis, as has been the norm to date, government must set absolute criteria for deeming banks "in need of resolution." After applying more stringent asset marks, as set forth above, the government should require any bank unable to prove at least 6% tangible equity net worth and Tier 1 capital ratios sufficient to be deemed "well capitalized" under current measurements (collectively, the "Minimum Criteria"), to submit to something we call Special Administrative Resolution ("SAR") by the government. All banks would be required to reckon their position under these measures by February 28, 2009. Thereafter, any bank not under SAR that subsequently falls below the Minimum Criteria will automatically fall under SAR. (Future write-downs will naturally force more institutions into SAR.) Sorry to say, though, we would also advocate a minimum size for banks that are SAR-eligible—perhaps $5 billion to $10 billion in assets is a rational cutoff (less than a couple hundred of the 8,400+ U.S. banks). Smaller toxic banks would have to restructure the old-fashioned way: recapitalize on their own, merge into larger institutions or be seized by the FDIC. The economy can function without them.

- The key to SAR would be that additional bank losses are effectively stopped out by the government with respect to assets on bank balance sheets prior to December 31, 2008. Such assets will continue to be written down pursuant to the more aggressive methods set forth above, but the government will infuse into the banks a sufficient amount of common or preferred equity to restore the Minimum Criteria. The goal is to announce to all and sundry (including potential common equity investors) that under no circumstances will a bank under SAR ever become insolvent (because of its bubble-era assets), either under GAAP or for regulatory purposes.

- Here's the ideologically challenging part, if you are a former Bush administration official: Any bank coming under SAR will grant the U.S. government warrants to acquire 79.9% of its common shares (think AIG here) subject to dilution by new capital. There, we said it. Is this "nationalization?" Well, a little—but not really. The government would not seek to control the subject institutions through voting rights or board representation. (OK, maybe a bit of executive-compensation restriction, just to make Congress happy.) What we are really proposing is setting things straight. The banks are guaranteed their survival and their preexisting shareholders end up with a "hope certificate" (20.1% of ownership) to maybe get some money back someday. That's a fair deal all around—a gift, really, to the otherwise wiped out shareholders and responsible compensation to taxpayers for bearing the burden of maintaining the banks.

- Capital provided by the government will first top up any deficit in the 6% tangible equity requirement (which could be accomplished with new funds or a conversion into common

of the already advanced TARP monies), and remaining capital will be injected by means of issuing the government perpetual preferred shares with a preferred dividend equal to the yield on the 30-year U.S. Treasury Bond plus 50 basis points (around 3.4% per annum today) fixed at the time banks receive funds. This preferred dividend relates to the government's cost of funds, plus a much smaller margin than Treasury has been asking for TARP monies, inasmuch as the taxpayer will now own the lion's share of the banks' common equity (no sense in charging a premium to yourself). The tangible equity top-up will be pari passu with all other common shareholders and will be booked as the sales price of the 79.90% warrants (which will be taken in full by the government upon entry into SAR, even if there is no tangible equity top up required initially).

- With the risk of insolvency removed, and the interests of the government more or less aligned with those of future shareholders, new investment in the banks can finally be considered. The size of the government stake in the common equity and its commitment—as a matter of policy—to healthy, reinvigorated banks should strike investors as a guarantee, of sorts, of eventual survival of the banks subject to SAR. While the servicing of the ultimate losses from the bubble-era assets will place a drag on earnings (to the tune of the low +/-3.4% dividend on the additional government preferred used to plug any future losses), the banks will be strong, face less competition in the short term and seek to do business again. While price will certainly be an issue for private investors in the short term, until the new business model is proven, the massively depressed share prices of traded banks offer a very attractive floor with the SAR regime we have outlined. We believe other investors would see it this way, as well.

- Yesterday, we saw statements out of the UK that Prime Minister Gordon Brown's government was seeking to enter into binding agreements with banks to commit to lending targets. A "Darling" little proposal that was—and inasmuch as the UK has already nationalized or quasi-nationalized a good number of its banks, we are not surprised. But such moves illustrate exactly what should not occur under our proposal. It is critical that the executive branch and the Congress not place banks under political control with respect to operations. Regulatory structures need to be strengthened to limit what banking institutions *can* do, but there should be no quid pro quo relating to the government's recapitalization of banks as to what they *must* do. This should be self-evident, based on what happened when our politicians told Fannie Mae and Freddie Mac to whom they must lend.

Are we naïve about the politics of all this? Perhaps. But following President Obama's stirring first inaugural address, we are inspired by President Lincoln's words, which Mr. Obama often quotes, and trust that our politicians will ultimately stand for the interests of our Union and economy "when again touched, as surely they will be, by the better angels of our nature." It is long past time to get off the unproductive treadmill of ideological limitations and address the real-world crisis in a pragmatic, productive way. That's what Americans do in times of challenge. As of now, with our zombie banks and overstated bank assets, we more resemble Japan in the 1990s than the United States anywhere near its best. Let's *not* keep that up, shall we?

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