WESTWOOD
CAPITAL, LLC

OPINION

September 23, 2008

Len Blum Managing Director • lblum@westwoodcapital.com • +1-212-972-2455
Daniel Alpert Managing Director • dalpert@westwoodcapital.com • +1-212-953-6448

Comments on Today's Hearings

Regardless of the merits of a $700 billion bailout, it most likely will get passed in one form or another. But Treasury Secretary Henry Paulson has proffered a proposal that is striking in its lack of detail. We believe the dearth of specifics may have been a strategic move to gauge reaction from legislators, market commentators and the markets themselves.

Of course, political agendas are emerging. Both presidential candidates have endorsed adding automaker bailouts to the package. And it's no wonder: Ohio and Michigan (the key auto-manufacturing states) are important electoral battlegrounds. But it would be ludicrous to assist the troubled auto industry. If General Motors or one of its domestic competitors were to go out of business, its plants and employees would quickly be assumed by a foreign competitor. A domestic company's failure would have little impact on our economy.

Beyond politics, here are some commonsense considerations:

- Treasury must purchase all assets at or below fair value. ***If Treasury were to purchase any asset above market value, wealth would be transferred from taxpayers to the institutions' management and stockholders.*** If an institution is undercapitalized after bailout, Treasury should purchase highly dilutive preferred stock, convertible into common shares in an amount sufficient to shore up the bank's capital. Management and shareholders should suffer for the mistakes made—not the taxpayers.

- Price is paramount. Treasury should not overpay. "Hold to maturity" values are illusory – we do not expect real estate to return to pre-bubble levels. And why should the selling institution's management and shareholders reap the rewards of increases in value during the holding period, if any, while taxpayers assume the risk.

- It's unnecessary to approve the entire $700 billion package at once. Congress should instead allow an initial purchase of $200 billion from the most troubled institutions. Treasury should then return to Congress for an additional allocation.

- Treasury should help only those institutions that are critical to our financial system. Aside from Fannie, Freddie and AIG, which have already been bailed out, six commercial banks and four non-bank insurance or investment banking companies

with assets in excess of $500 billion remain. These 10 institutions (13, including the three already in conservatorship)—all household names—are clearly systemically critical to our financial network and need to be recapitalized if they get into trouble. We estimate the loss of another dozen or two institutions could be disruptive—although not systemically calamitous—and should perhaps be added to the preservation list. But the line should be drawn somewhere, and federal intervention should not extend to all 8,500 existing U.S. banks. This is simply untenable and, more importantly, unnecessary and unwise. Troubled small banks will either fail or be acquired.

- Treasury should receive preferred shares convertible into common from any institution it helps.

- To the extent that homeowners receive assistance, it should be granted only to those who took out mortgages with traditional debt ratios (i.e., the mortgage debt service did not exceed 28% of the borrower's gross income) and where the mortgage has been re-underwritten to ensure all information about the borrower's income and assets were correct at the time of underwriting.

- To the extent that the government offers assistance to homeowners, it should participate in any appreciation of the home.

- Congressional oversight of Treasury is mandatory, but efforts must be competent. Let's not forget that Fannie and Freddie's regulator declared the agencies had sufficient capital only months before insolvency. And regulators cannot outsource analysis to rating agencies or a bank's CPAs. The buck has to stop somewhere.

The key issue in the resolution is this: The cost will be allocated between shareholders and management, on the one hand, and taxpayers, on the other—a direct result of the prices paid for mortgage assets. ***The lower the price Treasury pays, the lower the cost for taxpayers.***

In this morning's testimony, Fed Chair Ben Bernanke stated he intends to buy assets at "hold-to-maturity" rather than "fire-sale" prices, out of concern that such prices would leave banks with too little capital. We would rather see Treasury buy the assets cheap and use the remainder of the funds infused into the financial institution to buy preferred stock. Consider the following example:

Challenge: Bank X has loans on its books at $60,000. The hold-to-maturity price is $50,000, and the market value is $40,000. Bank X needs to sell the loans for $65,000 to be adequately capitalized.

Solution: Treasury buys the loans for $40,000. Treasury buys $25,000 of preferred stock with a coupon of 15%, convertible into common shares at a very dilutive rate. Treasury ignores the "hold-to-maturity price." Taxpayers are no worse off after the transaction.

They may take losses or gains on the mortgages and the preferred stock, but the outcome is two-sided.

Also note: There is no legitimate way to determine what a "hold-to-maturity" price really is—something Chairman Bernanke failed to address and for which no accurate model exists. Real estate should continue to depreciate, and it is unclear how many more homeowners will default. Let's err to the advantage of taxpayers.

This opinion ("Opinion") is for discussion purposes only and intended only for Westwood Capital LLC ("Westwood") clients. This Opinion is based in part on current public information that Westwood considers reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. Westwood's business does not include the analysis of any specific public company or the production of research reports of the same. Westwood may produce other opinions, published at irregular intervals. Westwood's employees may provide oral or written market commentary to Westwood clients that reflect opinions that are contrary to the opinions expressed in this Opinion. This Opinion is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction. It does not constitute any recommendation or advice to any person, client or otherwise to act or invest in any manner.