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OPINION

April 8, 2008

Len Blum Managing Director • lblum@westwoodcapital.com • +1-212-972-2455

Who Should Bear the Cost of Bailing Out Our Financial System?

With ample finger-pointing over The Bear Stearns Companies Inc. ("BSC") bailout several weeks ago, let's consider several tools the Federal Reserve Bank could have employed in connection with transactions that occurred and future rescues, should they prove necessary.

The following measures reduce taxpayer burden by shifting bailout costs to the troubled institution's shareholders:

1. Risk escrow facilities;
2. Market insurance premium transfer; and
3. Rights offerings.

On March 16, the Federal Reserve Bank executed an agreement with JPMorgan Chase & Co. ("JPM") and BSC to resolve the latter's financial distress. As part of the original deal, the Fed agreed to assume credit risk on $30 billion of BSC's illiquid securities. The *quid pro quo* was that JPM would guarantee certain BSC obligations. JPM also received rights to purchase 19.9% of BSC stock shares for $2 and an option to buy BSC's Midtown headquarters at a below-market price. JPM could purchase the remainder of BSC shares, but only subject to shareholder approval. Once the original deal was in place, the risk of a BSC failure was contained.

BSC shareholders, however, reacted to the original deal with outrage. In response, JPM quintupled the purchase price to $1.4 billion (or $10 a share). As part of the revised offer, JPM agreed to absorb the first $1 billion of losses on the BSC assets covered by the Federal Reserve Bank, while taxpayers were expected to shoulder the remaining $29 billion.

Why would the Fed allow BSC shareholders to receive $1.4 billion in value, while foisting $29 billion of risk on taxpayers?

This inequity needn't have occurred. A simple structure—the risk escrow facility—could have assured a fair transaction, as follows:

- All monies to be paid to the troubled entity's shareholders would be placed in escrow;

- Until BSC was fully liquidated, escrowed monies would be available to cover any losses on disposition of assets; and

- Remaining funds would then be distributed to BSC shareholders.

When dealing with at-risk financial institutions, regulators must require them to raise equity capital immediately. Subject institutions would include undercapitalized entities, institutions holding material amounts of illiquid assets and those with significant liability exposure (i.e., entities with significant, unstable short-term financing). For institutions lacking ready access to capital (without causing massive dilution), rights offerings provide a solution.

A rights offering is, as the name implies, an offering of rights to existing shareholders to purchase a proportional percentage of a company's securities. Its salient features include the date of exercise, the exercise price, transferability provisions and the number of shares that can be purchased. The lower the exercise price, *vis-à-vis* the then-current stock price on the exercise date, the higher the probability that the rights will be exercised.

Rights generally get exercised, unless the stock trades at or below the exercise price on the exercise date. By using a formulaic exercise price, however, savvy issuers can ensure this doesn't happen. In a formulaic offering, the rights are exercisable at a percentage of the security's trading price on the exercise date. For example, a right to a stock with a 50% formula, trading at $10 on its exercise date, could be exercised for $5. If the same stock was trading at $15 a share, the rights could be exercised for $7.50 a share. Furthermore, to ensure shareholders are treated fairly, rights can be transferable—advantageous because tradable rights allow for third-party verification of value. Holders of transferable rights can sell them in the market, thereby monetizing the dilution they otherwise would suffer if such rights expired unexercised.

Historically, domestic companies have hesitated to use rights offerings because there's a stigma surrounding them. U.S. companies want to avoid conveying the message that they "need" money. And they don't want to have shareholders perceive that the company is "holding a gun to their heads" for equity capital. However, such transactions are in widespread use in Europe and other foreign markets. Further, tradable rights offerings are the most equitable way for shareholders to have a "right of first refusal" to purchase new shares. Companies can also save significant investment banking fees, as rights offerings are much less expensive.

In particular, we would encourage Freddie Mac and Fannie Mae to raise capital immediately. These government-sponsored enterprises ("GSEs") employ extremely high leverage ratios, have histories of undependable accounting and continue to pile risk onto their already highly levered balance sheets.

Consider that Freddie and Fannie have tangible leverage ratios of 96.64% and 95.01%, respectively. This means unreserved losses of just 3.36% and 4.99%, respectively, could cause insolvency. Remember: These entities have tremendous exposure to the residential real estate markets, which are widely expected to fall further. Allowing these enterprises to operate at such unsafe leverage ratios imposes tremendous risk on our financial system and taxpayers.

While securities issued by Freddie and Fannie are not explicitly guaranteed by the U.S. government, the investment community widely perceives them to enjoy its implied credit support.

Allowing Freddie and Fannie to operate with tremendous leverage ratios benefits only their respective shareholders—not taxpayers. But taxpayers will bear the burden if and when these institutions collapse.

As a postscript, BSC has vehemently stated it had no liquidity or capital problems. Instead, its management contends there was a "run" on the bank. But BSC was not only financing long-term assets with short-term liabilities; material amounts of such liabilities were maturing daily. Prudent financial management dictates that a material portion of an entity's financial liabilities should not become due on a single day, or that significant portions of the balance sheet be financed on an overnight, rolling basis. Disquietingly, many investment banks operate in this fashion, and such high degree of risk should be highlighted in their public financial filings.

Len Blum is a Managing Director of the New York investment bank Westwood Capital, LLC, and its affiliates.Mr. Blum is a frequent commentator on the housing and credit crises on the CNBC, Fox, and Bloomberg networks, as well as in leading periodicals.