WESTWOOD CAPITAL, LLC

OPINION

September 19, 2008

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Falling Back to a New Redoubt

Overview

The new line in the sand drawn by the U.S. Treasury and Federal Reserve after this week's collapse of Lehman Brothers held successfully—for two whole days. Notwithstanding Treasury Secretary Henry Paulson's unambiguous statement that he never even considered, and will not consider, crossing the line (again) into the uncharted territory of moral hazards and fiscal dangers, he and the Fed invested in, and essentially seized, AIG and are now about to recapitalize the entire financial system (at least the part consisting of institutions they deem "too big to fail"). In just a few days, Paulson has ostensibly morphed from "ain't gonna go there," in terms of new offensive action, to a declaration that massive action is vital. The government, including a compliant and appropriately frightened Congress, is falling back to a new redoubt, from which it can defend the financial system and prepare offensive action to rescue the economy.

From the Secretary's statement this morning, it's apparent the Treasury, Fed and Congress have their work cut out for them this weekend—and we don't believe there's consensus on exactly how they're going to implement key elements of the Treasury's action outline. We are also concerned that some members of Congress will press the administration to add provisions to the proposed emergency legislation, which would provide for increased general stimulus to the economy and direct aid to distressed homeowners. While politically desirable, any such moves must complement other actions.

While we agree with the need to act in a decisive, focused manner, we believe government actions hereafter (that is, above and beyond those already in place, which do not require additional congressional approval) must focus on the following:

1) The organization of an aggressive triage effort to force the recapitalization of money center banks, large insurance firms and the two remaining Wall Street investment banks

2) The implementation, in a coordinated fashion among all agencies and government branches, of a mass-scale resolution to the remaining economic and financial devastation that awaits the continuing mortgage-loan default and foreclosure crisis (and the underlying housing price correction).

Further, Westwood Capital believes several objectives should take precedence in the anticipated intervention:

- Ensuring the safety and soundness of the U.S. financial system
- Enhancing the transparency of assets held by U.S. banks, thrifts and insurance companies
- Eventually, attracting new, private capital to the U.S. financial system
- Minimizing taxpayer cost and risk, while shifting as much risk and cost as possible to current financial institution shareholders
- Accelerating the quest for a sustainable level for U.S. home prices

Triage and Preservation of Critical Financial Institutions

Aside from Fannie, Freddie and AIG, which have already been dealt with, there are six remaining commercial banks and four non-bank insurance or investment banking companies with assets in excess of $500 billion. 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.

Secretary Paulson's statement this morning, while far-reaching and attention-getting (at least as far as the markets are concerned), left a significant number of unanswered questions about the new initiative to have direct government acquisition of distressed non-agency and other toxic assets:

- At what price will taxpayers purchase assets?
- How will taxpayers be exposed to losses?
- How will the shareholders and other stakeholders of troubled financial institutions share in any losses?
- How much capital will be devoted to these acquisitions and recapitalizations?

We believe Paulson and Federal Reserve Chairman Ben Bernanke have signaled their intentions, in the above regard, by virtue of their actions to date. The Treasury and Fed have demonstrated they intend to show little or no mercy to existing equity holders of financial companies requiring federal-government intervention and reconstruction. Further, they have gone so far as to demand "regime change" at the institutions they have conserved to date, dismissing senior management as a condition of the taxpayers' assistance. We therefore ask why financial shares rallied over the past two days on the expectation of a broadening involvement by this government in saving the financial system? We see no evidence to suggest that Paulson and Bernanke are interested in doing anything other than saving the financial system for the benefit of the rest of the economy and commerce, and not for the shareholders of banks, IBs (both of them) and insurance companies.

In that spirit, which we hope will continue to govern the actions of these two sleep-deprived, but indomitable, leaders, we offer the Westwood Plan for effectuating the policy goals Paulson articulated this morning:

- To avoid accusations of being arbitrary in the application of the resolution plan, or playing God, the plan should be made available to any institution with more than $500 billion in assets (or a lower number, if necessary), with the assumption that smaller institutions are not critical to the operation of the economy and financial system and will either resolve themselves or be consolidated into the larger institutions.

- Eligible institutions should have the option of participating in the government-offered program, but should not be forced to do so. The operative assumption here is that the program will be sufficiently onerous to the institutions so as to ensure that only those with no choice but to go bankrupt will elect to participate.

- The program's objective should be to ensure that participating financial institutions are returned to sustainable health. Thus, any government-injected capital should recapitalize the institutions to a conservative level (*i.e* to a significantly lower debt/equity ratio than has prevailed of late). This will require meaningful capital infusions from the government.

- To address concerns in Congress and among the general public regarding executive compensation levels, the program should place a salary cap on the compensation of any employee of an institution that is benefiting from taxpayer funds. We suggest that no senior management employee of any restructured institution should be eligible for more than $1 million per annum in total compensation (including the value of options and deferred compensation).

- As to funding, we propose the following formula:

    i. The Treasury or a special-purpose agency should acquire, for cash, all "Level 3" assets of subject institutions at 50% of their marked-down values as of Sept. 30.

    ii. The "Level 2" assets of the subject institutions should be acquired, if necessary, to an appropriate debt/equity ratio at 90% of their marked-down value.

    iii. All additional capital required to achieve the desired debt/equity ratio would be invested in the form of preferred shares.

    iv. With respect to the Level 3 and Level 2 assets acquired, the government would have the right to obtain additional preferred shares—at no additional cost—to the extent of any losses incurred at the time the government ultimately disposes of the assets, including the carrying cost of holding them until disposal. Any gains would be retained by the government.

- As to the preferred stock and balance of the terms of the program, we've already seen them. We expect the government to insist on nothing less than the deal it offered AIG—a preferred coupon of 850 bps over LIBOR, coupled with warrants to acquire 79.9% of the common shares of the subject institutions at a nominal exercise price. Effectively, this will wipe out the common equity value of the subject institutions for the time being, as it has with Fannie, Freddie and AIG. We would bite the bullet here also (and this is tough because we own bank preferreds) and call for the government-preferred to rank senior to all other preferred shares of the subject institutions, to the extent possible.

The foregoing (and the deals for FNM, FRE and AIG) is a tough and rigorous proposal that we hope will protect the U.S. taxpayer and possibly result in profits. But we acknowledge it is tantamount to de facto nationalization of the affected institutions, albeit in a form that doesn't bring them onto the U.S. government's balance sheet.

The Resolution of the Correction in Home Prices and the Foreclosure Crisis

Westwood has previously articulated what we believe to be the most effective way to resolve the housing crisis—and limit the ultimate losses therefrom, as much as is possible, given the housing bubble's magnitude. To us, the solution must adhere to five clearly articulated principles that: a) cause the parties that took unwise risks to also take responsibility for their acts; b) rely as little as possible on government/taxpayer aid to individual homeowners or lenders; c) strive to keep people in their homes; d) save lenders and borrowers the enormous cost of adversarial foreclosure; e) provide sufficient time for American families unable to afford continuing homeownership to work their way out of their mountain of debt and rebuild material savings.

There are presently fewer potential homebuyers than there are available homes for sale, so the best option for many "underwater" homes and their occupants is to offer market-rate leases in exchange for the surrender of deeds, in lieu of foreclosure and sale. Our suggestion in this regard would promote accelerated settlement, between borrower and lender, of impaired mortgages. For the purposes of the Plan, an impaired mortgage loan is one that is both (i) seriously delinquent or defaulted, and (ii) collateralized by a home that is worth less than, or only slightly more than, the mortgage debt it secures. Settlements under our plan would involve homeowner/borrowers with impaired mortgage loans to voluntarily surrender to their mortgagees the deeds to their homes, in consideration of the right of continued occupancy for a period of five years as tenants. This Plan would provide cost savings and incentives to both borrower and lender, as detailed below, so as to encourage them to settle without going through the very costly proceedings of foreclosure or bankruptcy. The federal government, in addition to providing certain tax incentives, would assure compliance with the plan by lenders availing themselves of it.

This Recovery Lease-based plan would dramatically reduce the social and economic impact of continuing, massive dislocation in the housing market. Moreover, this proposal would limit the taxpayers' exposure from being forced to intervene in the financial system as set forth in the first part of this Opinion. While the plan would involve only private market

transactions (outside of the contested foreclosure process), government would enact the following to encourage the participants to move in this direction:

- Grant tax deductibility to all or a portion of rents paid on Recovery Leases to lessen the burden on the former homeowners (just as they were previously deducting mortgage interest)—leveling the playing field between owning and renting for existing owners of homes secured by troubled mortgages.

- Establish mandated benchmarks and guidelines for rents that can be charged under Recovery Leases, based on prevailing rents in the local submarkets in which the homes are located. (During the housing bubble, market rents fell well below the carrying cost of ownership in most markets.)

- Enable financial institutions and subsequent investors in the homes to rapidly depreciate the value of the homes they have taken over, reducing depreciation periods from 28 to 18 years.

- Remove passive-activity loss limitations in the case of homes subject to Recovery Leases, thus providing enhanced tax incentives to individual investors interested in buying Recovery-Leased real estate.

- Mandate a right of first offer to the former homeowner/Recovery Leaseholder, pursuant to which the occupant would be offered a 90-day right to buy the house at the price at fair market value just prior to the expiration of the 5-year Recovery Lease term, if the occupant is able to do so.

In the event the now-renting occupants stop paying their rent, they would be subject to eviction as in the case of any lease. Most important, all of this should be viewed as an emergency measure and should have a defined sunset—applying only to Recovery Lease arrangements made for the next 18 to 24 months or so, thereby forcing maximum resolution into the shortest period of time. Finally, lenders should be encouraged to monetize (sell) the homes, subject to the Recovery Leases, as soon as possible to get the assets off their balance sheets and permit professional investors to replace the repossessed real estate with cash, on the balance sheets of lenders, to improve regulatory capital.

A Word about Today's Short Selling Restrictions

While we believe relief is necessary from short sellers, it's also important to acknowledge the function short selling plays in our markets. The options, futures and stock markets are remarkably intertwined. Sales in one market often trigger purchases in another, and vice versa. These connected transactions ensure our capital markets are in sync. Should they lose their synchronicity, the relatively high (low) market is sold (bought), and traders hedge their exposure in one market to another.

Consider the case of the options desk at a bank that sells a put to and buys a call from a client. The bank will then need to short the underlying stock—not as a "casino bet," but as a risk-neutral hedge. Or consider a futures buyer who simultaneously sells stock—a risk-free arbitrage, not a casino bet.

Given the importance of the ability to sell short to market efficiency, we want to highlight it—and caution that any prohibition should be temporary.

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