WESTWOOD CAPITAL, LLC

OPINION

October 10, 2008

Daniel Alpert Managing Director • dalpert@westwoodcapital.com • +1-212-953-6448

Government Recapitalization of Banks

We wrote early last week (before Secretary Paulson presented his latest plan) to urge that a large portion of the TARP funding be redirected to direct recapitalization of the banking sector. Inherent in our comment, however, was the notion that such an effort needs to be accompanied by an intelligent triage exercise. However fair or unfair, it would be wasteful of taxpayer funds to infuse funds in some sort of open auction for capital among all institutions that can still fog a mirror.

There have been some suggestions put forward to consider data such as bank's so-called Camel ratios (which consider a range of analytical inputs, such as Capital, Asset quality, Management, Earnings and Liquidity), in determining which institutions should be acquired, in part, by the US government. Some in Congress and the business community have called any attempts at bank-triage tantamount to "playing God."

Perhaps we need a little God in our fiscal lives right now. A loving God, of course, but also one capable of making the hard choices regarding the institutions that can be safely sacrificed so that the banking and financial system can survive and prosper again. This notion is heavily infused with concepts of moral judgment that are present in most every culture - and no culture or country is entirely comfortable with assigning to any individual or body the power of life and death (albeit, here, we're talking about banks - not souls). But in the current situation, it should be apparent to all that our resources are inherently limited and not all institutions need survive. This is wartime, financially speaking, and in war difficult judgments must be made and some firms will need to be fodder for the preservation of our global economic way of life.

Away from this moralizing, a few practical thoughts:

- It is extraordinarily difficult (read, "nearly impossible") to triage the current population of banks based on CAMEL or any other static analysis. The financial inputs are changing so rapidly, and because of poor regulatory oversight, so little is really transparent regarding the current condition and/or trends of each institution's asset quality, that basing rescue efforts on such "objective" data materially risks throwing good money after bad.

- Triage doesn't necessarily mean the weak must perish á la Lehman. Temporary nationalization and resale to the private market worked surprisingly well with four large banks in Japan (one of which, Long Term Credit Bank, was renamed Shinsei by its buyer - meaning "new life" or reborn). But, more importantly, as full nationalization of large institutions is not on the first page of anyone's playbook in this country, another lesson from Japan's crisis is already taking root here - and should be continued: After exhausting their political and fiscal resources on four high profile nationalizations - and seeing the banking crisis worsen - the mandarins of MOF turned to "arranged marriages." Essentially, they shrank the number of money center banks by "inviting" them to merge. In addition to creating some pretty oddly named institutions (we'd walk you though the begats of MUFG, but call us later for that), it reduced the risk of making bad choices support-wise in recapitalization. MOF, by the way, hadn't a clue either about the asset quality of the institutions it was saving. The Japanese example is limited in the fact that "face saving" (of the bank's management) was an issue in their rescue efforts - which is not exactly an American cultural imperative. But the method of "merge and recapitalize" has merit all the same. And look what a nice tussle ensued with Wachovia/Citi/Wells - sure enough even the private sector sees the advantage of fewer and bigger institutions (not surprisingly, of course).

- Finally, and this is the key issue, if the government is going to need to wade into the ownership of our banking institutions (and we see little ability to avoid that at this juncture) it really only makes sense to recapitalize those institutions (or merged institutions) with substantial market shares and responsibility for the bulk of the banking commerce that goes on in the US. We realize that this is an inherently anti-competitive notion - but how many large and powerful institutions does the US really need to foster solid competition in the banking sector..... a half-dozen, a few more? Look at Canada for a point of reference (OK - they're tiny - but they've got comparatively healthy big banks). In fact, and here we'll go out on a limb, perhaps one could even argue that too many banks engender too much competition which results in too much ill-advised lending by market-share-obsessed management teams.

We are facing another dilemma in connection with rescuing the banking system. And that is that recapitalizing the banks (even following the above advice) does just that - allow them to survive. Since we still need to resolve and settle all the trillions of bad debt and crazy inter-institutional (CDS, etc.) obligations, no one really knows how much capital will be needed - other than "a lot." That's the reason private capital has been so reticent. Even the bargain-basement Buffett buys are not (and he'd, no doubt, agree) without risk of further dilution. A well executed triage effort, as outlined in part above, would allow greater ability to accelerate the resolution of impaired assets and will have a much higher probability of attracting private capital in sooner (on the heels of government investment) to the fewer institutions (or combinations thereof) that are truly systemically critical.

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.

This Opinion is disseminated primarily electronically and, in some cases, in printed form. Electronic research is simultaneously available to all clients. Disclosure information is also available at http://www.westwoodcapital.com/.

If this Opinion is being distributed by an entity other than Westwood or its affiliates, that entity is solely responsible for distribution. This report does not constitute investment advice by Westwood, and neither Westwood nor its affiliates, and their respective officers, directors and employees, accept any liability whatsoever for any direct or consequential loss arising from use of this Opinion or its content.

Daniel Alpert is a Managing Director and Founding Partner of the New York investment bank Westwood Capital, LLC, and its affiliates. He is a frequent commentator on the housing and credit crises on the CNBC and Bloomberg networks, as well as in leading periodicals.