

Preferred Market Update

Summary

It has been an eventful summer in the preferred market. Treasury yields have declined significantly on renewed worries about the sustainability of the economic recovery. Despite the concerns over the economy, however, most companies posted stronger earnings, and preferred security prices generally moved higher over the summer months. Legislators and regulators were busy. Congress passed the Dodd-Frank financial reform bill in July. More recently, the Basel Committee on Banking Supervision proposed new requirements for bank capital securities that – if adopted – would significantly change the nature of bank preferred and capital securities in the future. We briefly describe the more-important aspects of these developments for preferred investors and offer our thoughts about their impact on preferred securities.

Economic Outlook

We will begin with a brief update on our thoughts on the U.S. economy.¹ In short, economic activity slowed over the course of the second quarter and is likely to remain sluggish in the second half, though we think fear of a double-dip recession is overdone. Employment growth has slowed, but the private sector continues to create new jobs. Growth in real personal consumption expenditures held about steady at 2.0% in Q2 (compared to 1.9% in Q1), but real disposable income grew by 4.4%, allowing the personal savings rate to rise to 6.4% by quarter-end. While investors have been wringing their hands over the slower spending, they have overlooked the substantial progress consumers have made increasing their savings. Consumption necessarily grows more slowly than income as consumers increase their savings rates. While the savings rate probably will move somewhat higher, we think a large portion of the adjustment has already occurred.² As a result, we think consumption will continue to grow even though job and income growth are tepid. This sustained consumption growth eventually will cause job growth to accelerate. In the meantime, businesses continue to invest in equipment and software to improve competitiveness. The combination of moderate consumer spending and sturdy business investment is keeping U.S. factories busy, even though the pace of growth is slowing.

The economy does face some headwinds, however. Inventory growth has contributed significantly to Gross Domestic Product (GDP) in recent quarters, but that should begin to ease in the second half of the year. Recent survey data from the manufacturing sector suggests that this is underway. Similarly, the boost to the economy from fiscal stimulus will last a little longer, but it is likely to turn from stimulus to restraint before the year is out, barring passage of another big stimulus bill. Federal personal income tax rates – including those on qualified dividend income paid by many preferred securities – are slated to revert to higher levels on January 1, 2011. While Congress probably will extend many of the lower tax rates, it is not clear exactly which ones or how long they will survive. Finally, a wider trade deficit – in part a reaction to

¹ For a detailed discussion, please see the Flaherty & Crumrine *Second-Quarter U.S. Economic Update*, July 16, 2010, available at www.preferredincome.com or www.fcclaymore.com.

² The personal savings rate ranged mostly between 7% and 11% for most of the period from the late-1950s to the mid-1980s, after which household debt-to-income ratios began to rise significantly. We think the savings rate will move back into that range over the next several years.

demand for “safe-haven” U.S. financial assets – will probably further trim GDP growth going forward, although given how bad the trade numbers were in Q2, we would not be surprised to see some temporary improvement in Q3.

Adding it all up, we have seen nothing in the month since our last *Economic Update* to change our view on the economy. We anticipate slower growth (in the low 2% area) in GDP in the second half of the year, but not a double-dip recession. While that growth rate will not set off many celebrations, we think it is good news for credit markets. Industrial and utility companies should continue to operate cautiously yet profitably, with stable to lower leverage and smaller funding needs. Financial companies should continue to build capital and reduce risk, and their profitability is improving. Finally, interest rates should remain relatively low. We anticipate continued improvement in the overall financial health of the corporate and financial sectors.

The more-subdued economic news prompted a policy shift at the Federal Reserve and sparked a sizable rally in Treasury bonds. As part of its response to the financial crisis, the Fed purchased \$1,250 billion in agency mortgage securities and \$175 billion in agency debt, along with \$300 billion in Treasury securities. These purchases were completed by the end of March 2010. Since that time, the Fed has been reinvesting the interest and principal proceeds of the Treasury portfolio into new Treasury securities, but it had not been reinvesting proceeds from the agency mortgage and debt portfolios. By not reinvesting those proceeds, the Fed shrunk its balance sheet and drained reserves from the banking system. At the August Federal Open Market Committee (FOMC) meeting, the Fed decided that it will reinvest the proceeds of the agency mortgage and debt portfolios in Treasury securities. This gradually will reduce the Fed’s holding of agency mortgages and debt while increasing its Treasury portfolio by a like amount, leaving total reserves unchanged. This incremental easing in monetary conditions contributed to a sharp rally in Treasury bonds. The yield on the 30-year Treasury today sits at 3.58%, down from 4.20% at the end of May and roughly 4% at the beginning of August.

Regulatory Update

On the regulatory front, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010. Without attempting to summarize Dodd-Frank in its entirety, several of its provisions are important to the preferred securities market. We will focus our comments on those.

One of the goals of Dodd-Frank is to make banks better able to absorb unanticipated losses. To that end, the “Collins Amendment” requires that Tier 1 capital of *bank holding companies* be comprised of instruments that meet the definition of Tier 1 capital for insured *depository institutions*. While that sounds like a minor distinction, it’s a big deal. Here’s why. The only capital market instruments that qualify as regulatory capital for a bank depository institution (the operating company) are common equity and noncumulative perpetual preferred stock. They stand first and second in line, respectively, when absorbing unanticipated losses at the bank.³ Typically, the operating company is owned by a holding company. Under the old rules, a bank holding company was allowed to issue Trust Preferred Securities (TruPS) at the holding company level, where it was counted at Tier 1 capital. The holding company could then

³ Loan loss reserves and other reserves are there to absorb *anticipated* losses.

downstream the proceeds from the TruPS to the operating company as either common equity or noncumulative perpetual preferred stock.

Dodd-Frank changes that arrangement. After a phase-out period, TruPS will no longer be eligible as Tier 1 capital for large bank holding companies, though they will still count toward total capital.⁴ (See Table 1 for a summary of the various forms of bank capital.) Capital market instruments that will continue to qualify as Tier 1 capital will be limited to common stock and traditional preferred stock – although even the latter would not qualify under more stringent requirements being proposed under Basel III (see below). In addition, the legislation sets two floors under future bank capital requirements. First, capital ratios can be no lower than those in effect at the time of enactment (see Table 2 below). Second, capital requirements can be no lower than those “generally applicable” to banks. In practice, this means large banks will have to meet the same capital requirements as smaller banks, with no “discount” to the capital ratios for larger size and greater diversification.

Dodd-Frank also prohibits bank proprietary trading and the sponsorship of hedge funds and private equity funds (the “Volker Rule”), pushes out certain derivatives activity from the insured depository institution, and creates a Bureau of Consumer Financial Protection to regulate consumer-oriented financial products.⁵ These provisions will reduce both the amount of risk that banks can take and their profits. As preferred investors, lower risk is good, since it reduces the chance of default. However, lower profitability is bad, since preferred securities ultimately are paid out of earnings (on either a pretax or an after-tax basis). On balance, we think the reduction in bank profitability due to the legislation will be modest while the requirements for more and higher-quality capital will provide meaningfully stronger protection for preferred investors. Although Dodd-Frank will usher in many changes in the way banks manage their capital, we do not think its intent or consequence will be to eliminate the bank preferred market. Overall, *we view it as a net positive for preferred investors.*

⁴ Although no newly issued hybrid capital instruments (TruPS) will qualify as Tier 1 capital for any bank, issues outstanding prior to May 19, 2010 will be “grandfathered” as follows. For banks with less than \$15 billion in assets as of December 31, 2009, hybrid issues will be permanently grandfathered. For domestic banks with \$15 billion or more in assets, hybrid instruments will receive 100% Tier 1 credit until January 1, 2013, falling to no credit on January 1, 2016. Regulators will decide the phase-out percentages, but presumably those will be 75% in 2013, 50% in 2014, and 25% in 2015. The timetables are slightly different for thrift holding companies and U.S. holding companies of foreign banks. In addition, the hybrid capital rules do not apply to Federal Home Loan Banks, small banks with less than \$500 million of assets and certain mutual holding companies.

⁵ The Consumer Bureau will reside with the Federal Reserve and is authorized to spend up to 10% of the Fed’s budget, which will make it a sizable regulatory entity. However, the Bureau will not report to the Fed Board of Governors or Chairman; it will be an independent regulatory body. We will have to monitor how the Bureau (mandate for consumer protection) and the Fed (mandate for banking system safety and soundness) balance their sometimes-conflicting mandates.

The Basel Committee on Banking Supervision has also been busy this summer.⁶ In July, the Committee published a Countercyclical Capital Buffer Proposal. This proposal would require banks to increase capital ratios in response to excess credit growth or permit them to reduce capital ratios in times of financial stress. The technical details of the proposal are complex and not suitable for this discussion. Although there is little controversy over the goal of the proposal – build additional reserves during “good” times and reduce them during “bad” times – the identification of those periods in real time is always difficult. Nonetheless, if thoughtfully implemented, the proposal should help dampen credit cycles and probably would lead to additional preferred issuance, since callable preferreds could be easily retired once the need for additional capital had passed. Both of those outcomes should be good for preferred investors.

The Basel Committee followed this proposal with a far more controversial one in earlier this month. The Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability would require that any instruments issued by systemically important international banks that are treated as regulatory capital must “include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability.” The proposal is aimed at large, systemically important international banks; smaller banks would be wound up under existing resolution authority, with losses to preferred securities allocated in the normal course of bankruptcy or receivership. The proposal contemplates two loss-generating mechanisms for these preferred capital instruments, which would need to occur prior to any public-sector equity injection: (i) an outright write-off of the principal amount of the security or (ii) conversion to common equity. There would be two trigger events for losses: (i) a decision to inject public capital, without which the bank would be non-viable, or (ii) a decision by regulators that write-off or conversion is necessary to avoid the bank becoming non-viable. If a bank chooses to make equity conversion the loss-generating mechanism (and we presume investors would demand this compensation⁷), then the bank must continuously maintain sufficient share authorization to issue all common shares required under the conversion mechanism.

⁶ The Basel Committee is a group of international bank regulators charged with forging common international standards for bank capital and supervision. Regulators in individual countries may adopt the standards in whole or in part. Interested readers can view all Basel Committee proposals at www.bis.org.

⁷ We assume this because with the write-off alternative, preferred claims would be extinguished prior to common equity claims, which is contrary to the concept of preferreds being senior to common equity.

Table 1: Condensed Summary of Regulatory Capital Instruments

| Instrument | Old Treatment | Dodd-Frank | Basel Proposal |
|----------------------------------|--|--|---|
| Common Equity | Tier 1 – unlimited amount | Tier 1 – unlimited amount | Tier 1 – unlimited amount |
| Preferred Stock | Tier 1 – up to 50% (including any TruPS below) | Tier 1 – limit to be determined by regulators | Ineligible for internationally active banks (to be defined) |
| Trust Preferred | Tier 1 – up to 15% for internationally active banks, 25% for other banks | Tier 2 after phase out | Ineligible for internationally active banks (to be defined) |
| Contingent Convertible Preferred | N/A | Regulators will conduct a study to determine eligibility, required features, and capital treatment | Tier 1 or Tier 2 depending upon features; must be convertible into equity or written off at discretion of regulator |

Table 2: Summary of Bank Regulatory Capital Requirements

| Capital Level | Current Rules | Dodd-Frank | Basel Proposal |
|----------------------|------------------------------------|---|-----------------------|
| Tier 1 Common | Not specified | Not specified. Regulators may set requirement | TBD; perhaps 4-6% |
| Tier 1 Total | 4% minimum; 6% “well capitalized” | TBD. Not lower than current rules | TBD; perhaps 8% |
| Total Capital | 8% minimum; 10% “well capitalized” | TBD. Not lower than current rules | TBD; perhaps 10-12% |

The proposal makes no statement on grandfathering of existing capital instruments or on a timetable for implementation. Even if it were adopted by the Basel Committee – and then adopted by U.S. bank regulators – we think it would involve a long phase-in period. Nonetheless, if adopted in the proposed form, the loss absorbency proposal would dramatically change the bank preferred market.

We think trying to force preferreds to become equity outside of receivership or bankruptcy as a means of enforcing loss absorption is a mistake. Common equity absorbs losses equally on both a going- and gone-concern basis. Current preferred securities absorb losses for a going concern by allowing the temporary or permanent deferral of dividends in the case of cumulative or noncumulative preferreds, respectively. They absorb losses for a gone concern by virtue of their subordination to the claims of more senior creditors such as depositors and senior unsecured debt holders. The Basel Committee proposal would effectively convert all preferred and subordinated debt to equity at the discretion of regulators. This bit of alchemy is a big change for the market, and one that would drive many investors – and perhaps even the rating agencies – to reevaluate their participation in the bank preferred and subordinated debt markets. The Committee would

argue that the conversion or write-down will only take place at the point at which the bank would have failed anyway. We are skeptical, since regulators would be incentivized to move early to avoid reaching a crisis situation in the markets. In any event, investors would need to be paid handsomely to take on this additional risk, raising the cost of cost of capital for banks and, thus, the cost of credit for borrowers.

The current Basel proposal is likely to meet significant resistance from both issuers and investors, and it's not at all clear that U.S. bank regulators would accept it. In our view, if it's pure common equity that regulators want banks to hold as Tier 1 and Tier 2 capital, then that should be the requirement. However, it is better for regulators to acknowledge there are varying degrees of loss absorbency for both going concerns and gone concerns and to prescribe capital requirements that allow an effective and prudent allocation to each of them in the capital structure. We will be keeping a watchful eye on this proposal over the coming months.

Following passage of Dodd-Frank but before the Basel Loss Absorbency proposal last week, we had come to some preliminary conclusions regarding the direction of the preferred securities market. First, it seemed that most large-bank TruPS would remain outstanding until at least January 2013 given that (a) it would be expensive to replace a tax-deductible Tier 1 TruPS with non-tax-deductible common or preferred stock, (b) banks need to obtain regulatory approval for each redemption (not an easy task in the current environment), and (c) banks still are not sure what future capital requirements will be, only that they likely will be higher than they are today. Except for a handful of expensive high-coupon TruPS, early redemption seemed unlikely. We still think that's the correct conclusion. Things are more ambiguous for discount (i.e., lower-coupon) TruPS after January 2013, however. Prior to the Basel announcement, an issuer's decision to keep a TruPS issue outstanding depended on the cost of replacing Tier 2 capital (since TruPS would still count as total capital under Dodd-Frank). If Basel disqualifies TruPS from both Tier 1 and Tier 2 capital, then they would be essentially debt, and the refinancing hurdle would be much lower. We will have to wait and see on those issues. Regardless of the final decision, because most TruPS issues are trading below their regulatory call prices currently, the impact of any such calls would be generally favorable to preferred market performance over the short term.

Second, we anticipated a small increase in bank preferred stock (i.e., traditional noncumulative perpetual preferred) issuance, since that clearly qualifies as Tier 1 capital under Dodd-Frank. We did not expect a deluge, simply because most banks do not need the additional capital at the moment, and there is still uncertainty over how much capital they will need to hold in the future. However, if a bank wanted to issue preferred capital, it would have to be preferred stock, so we thought we would see some issuance later in 2010 or early 2011. The Basel Loss Absorbency proposal probably puts a lid on any preferred issuance, at least until the Committee decides whether or not to proceed with the proposal. Banks will not want to issue preferred stock only to have its capital eligibility eliminated. With TruPS on their way out and traditional preferreds in regulatory limbo, we expect that it will be a very quiet autumn for new preferred issuance.

Conclusion

The economic and regulatory environment continues to be favorable for preferred securities. We believe the economy will grow fast enough to allow credit quality to improve and to facilitate household deleveraging, but not fast enough to create much demand for new borrowing. Monetary policy should remain accommodative, and interest rates should remain low. The regulatory landscape, while changing rapidly (and sometimes unpredictably), should encourage financial institutions to reduce risk in aggregate and require them to hold more capital against the risks they do take.

Preferred securities make sense for financial issuers and we believe will be part of the capital structure in the future, but issuance will be determined only after a balance is struck between regulators' desire for counter-cyclical capital buffers and investors' desire for quantifiable risks and fair compensation for those risks. In the near- to medium-term, as this balance is being negotiated, we foresee little issuance of preferred securities. Preferred prices have rallied in response to these developments, but we still think they offer good value, especially in comparison to other investment grade fixed income securities. Markets are always uncertain, but we think patient long-term investors will be well rewarded in preferreds.

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