

Preferred Market Update

Summary

- We anticipate improved but still moderate economic growth with low inflation in the United States.
- Credit conditions remain favorable and continue to improve.
- Recently finalized bank capital requirements will strengthen the banking system and offer greater protection to preferred investors.
- Although some regulatory uncertainty has been resolved, most of the provisions of the Dodd-Frank financial reform legislation have yet to be announced, creating both risks and opportunities in the preferred market.
- While the very strong returns of the past two years will not be repeated in 2011, we still see good relative value in preferred securities.

Economic Outlook

The U.S. economic recovery that has been underway since mid-2009 remains intact and, if anything, has accelerated in recent months. Our views have not changed significantly since our last *Economic Update* in January, so we will just touch on the main drivers of our outlook here.¹ After posting modest growth of 2.8% in 4Q2010, real Gross Domestic Product (GDP) is likely to accelerate above 3% in 1Q2011. Employment growth, which is critical to the sustainability of the recovery, is gradually increasing. Job gains have averaged 136,000 per month over the past three months, compared to job losses during the summer months. Wage growth remains subdued, however. As a result, nominal wage and salary income has grown by a modest 3.8% over the past year (through January) and by just 2.8% annualized over the past three months. This leaves only limited room for consumers to increase real spending, especially with gasoline costs taking up a bigger slice of household budgets. Moreover, we believe consumers still want to increase savings and pay down debt, which will further dampen personal spending growth. We don't think any of this will derail the recovery, but it points to moderate rather than strong growth in personal consumption expenditures.

We continue to see good prospects for business investment spending. Corporate profits and cash flow are strong. Inventories are lean again in the wake of stronger than expected demand in 4Q2010, which should lead to renewed inventory investment in the coming months. Capacity utilization, while still relatively low, is rising and should drive further investment in 2011. In addition, businesses are likely to take advantage of special tax incentives for investment that expire at the end of 2011, which should accelerate some business spending into this year.

The trade and government sectors, however, are likely to exert some drag on growth in 2011. The trade deficit is widening again, partly due to higher oil prices but also due to rising business and consumer spending in the U.S., some of which is being satisfied by foreign products. Federal fiscal stimulus has largely run its course, and Congress is now wrestling with spending cuts and tax increases to try to reduce an unsustainably large budget deficit. State and local governments are trimming spending and shedding workers. Just as foreign trade and government spending

¹ See *Fourth-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, January 2011, available at www.preferredincome.com or www.fcclaymore.com.

helped support GDP through the recession, they will be headwinds to growth as the recovery continues.

On balance, we expect moderate growth of 3% or slightly more in the first half of 2011, perhaps slowing a bit in the second half as inventory growth decelerates. This growth pace should be fast enough to generate good corporate profits and moderate job growth, to gradually push down the unemployment rate, and to facilitate ongoing deleveraging by households. But growth should not be so rapid as to cause inflation to accelerate worryingly or to prompt the Federal Reserve to tighten monetary policy. As always, there are risks on both sides of this view, especially in light of the tragic earthquake and tsunami in Japan and unrest in the Middle East. However, at the moment we are not particularly worried about either a double-dip recession or growth that might push interest rates or inflation significantly higher. This adds up to a benign economic environment for preferred securities.

Credit Outlook

Credit metrics in the U.S. continue to improve along with the economic recovery. Corporate profits as a percentage of GDP are near all-time highs. Corporate balance sheets are healthy and improving: Liquidity is at an all-time high, companies have extended debt maturities and interest expense as a percentage of earnings before interest and taxes has fallen sharply and is nearing historic lows. The corporate “financing gap” (corporate financing needs less internally generated funds) was negative in 4Q2010, and it has been vacillating around zero for the past two years. This means that companies have the ability to finance virtually all of their expenditures with internally generated cash, and it has kept borrowing in the capital markets relatively low. We expect these trends to continue in 2011, although the pace of improvement is likely to slow as corporations start to shift from repairing balance sheets to growing their businesses again.

Households are also making progress deleveraging their balance sheets. Mortgage debt continues to shrink rapidly on sluggish home sales and write-downs from foreclosures – something that is unlikely to change anytime soon. Consumer credit is edging higher as automobile sales recover, even though credit card debt continues to decline. Since mortgage debt is much larger than consumer debt, aggregate household debt should continue to shrink for some time to come.

As companies and households have gotten healthier, their borrowing needs have diminished while their net savings have increased. This has created a powerful tailwind for tighter spreads in credit markets, and preferred securities certainly have benefited from this. We expect this favorable credit environment to persist for some time. However, with credit spreads already having recovered from crisis levels, investors should not expect the sorts of returns from 2009 or 2010 to repeat themselves in 2011.

Regulatory Update

There are two related regulatory measures moving through the banking system, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the Basel Committee on Banking Supervision’s third version of international bank capital standards (Basel III). We have previously described some of the features of each of these regulatory frameworks; here we will offer a brief update on where they stand.²

² See *Preferred Market Update*, August 2010, and *Comment on “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability,” Basel Committee on Banking Supervision*, September 2010. Both are available at www.preferredincome.com or www.fcclaymore.com.

There has been little news on Dodd-Frank since its passage in July 2010 that is of importance to the preferred securities market, though much is happening behind the scenes. The legislation required that regulators hire staff and conduct myriad studies before setting final definitions and proposing new regulations. While some of those studies have been released, most are due by July 2011, one year from the passage of the Act. Of primary importance to investors in preferred securities are the regulations surrounding bank capital requirements: How much and what types of capital banks will be required to hold and what features securities will need to qualify as a particular form of capital? We expect regulators to offer preliminary rules on capital in June or July, followed by a comment period of several months. That should put the market on track for final U.S. bank capital rules in 4Q2011. For bank Tier 1 Trust Preferred Securities (TruPS) that have regulatory call features, those final regulations may open the “window” for banks to call those securities, even though they will continue to fully qualify as Tier 1 capital until January 1, 2013. Not all banks will be in a position to call their TruPS, and banks that are able to call their TruPS may not do so with all (or even any) of their outstanding issues. What gets called and what gets refinanced will depend upon the final rules, a bank’s capital position, and the cost of issuing any replacement capital security. It’s going to be an interesting period, and we have spent considerable time thinking through how it might play out and how we might adjust our clients’ portfolios.

In December and January, international bank regulators finalized the Basel III bank capital standards. Under Basel III, banks will be required to maintain much higher levels of capital in the past, particularly at the common equity level. Minimum common equity capital will rise from the current 2.5% of risk-weighted assets (RWA) to 7% including a “capital conservation buffer”³ when fully implemented in 2019. The Tier 1 minimum increases to 8.5%, and minimum Total Capital rises to 10.5%. In addition, banks will be subject to a “countercyclical” capital buffer ranging from 0% to 2.5%, as determined by national regulators, and to a “systemically important financial institution” capital buffer whose size and application have not yet been determined. Those capital buffers may be met by common equity or certain forms of contingent capital securities⁴, including some preferred securities. While individual countries still need to adopt these standards, we expect that the great majority will do so. In fact, Switzerland has already announced that its two systemically important banks, UBS and Credit Suisse, will be required to hold total capital of at least 19% of RWA, including a Tier 1 common equity ratio of 10% – well in excess of the Basel III standard. We reproduce the Basel III table of capital requirements and the phase-in schedule at the end of this memo.

The other major piece of news out of Basel that affects preferred investors is that the Committee finalized its loss absorbency rules for preferred securities largely as originally proposed, with an important exception. The Committee had proposed that non-common capital securities qualifying as Tier 1 or Tier 2 capital needed to “include a mechanism in their terms and conditions that ensures they will take a loss at the point of non-viability.” Since current preferred securities – even those with features that would otherwise allow them to qualify as Tier 1 or Tier

³ The capital conservation buffer will be 2.5% of RWA, making the minimum common equity capital standard 4.5%. Banks that fall below 7% (i.e. 4.5 + 2.5%) common equity will face restrictions on employee compensation, shareholder dividends, and share repurchases. As a result, we see 7% common equity as the operating minimum under the new standards.

⁴ Contingent capital securities (“Cocos”) are securities that either convert into common equity or are written down upon some pre-specified capital event, such as Tier 1 common equity falling below a certain level. The common equity conversion moves the face value of the instrument into common equity, while the write down creates a gain that (after taxes) boosts retained earnings, both of which increase the common equity ratio.

2 capital – generally do not explicitly incorporate such terms, it was feared that virtually all bank preferred securities would become ineligible as Tier 1 or Tier 2 capital. Fortunately, the final rule gives national regulators an “escape clause” on this requirement. If a country’s bank resolution regime incorporates a system for allocating losses to capital providers prior to the injection of state funding, then the loss provision language is not required. While we won’t know for sure until final rules are written, it appears that Dodd-Frank gives bank regulators just such authority. As a result, it is likely that perpetual, noncumulative U.S. bank preferreds eligible for the dividends received deduction will remain qualifying Tier 1 capital under the new rules. Other countries are likely to adopt similar resolution regimes as well.

Finally, banks in the U.S. and Europe have completed or are currently undergoing another round of “stress tests” given by their regulators. So far, Spain and the U.S. have completed their bank stress tests, although only Spain has released its results. Its two largest banks, Santander and BBVA, are not required to raise any additional capital (as expected), while a number of smaller banks are required to raise a total of €15.1 billion of common equity capital, a relatively modest (and perhaps ultimately insufficient) amount. In the U.S., a number of large banks received permission from the Federal Reserve to increase their common dividends.⁵ In addition, several other banks received permission to repay their Troubled Asset Relief Program (TARP) preferred capital after raising a smaller amount of common equity capital.⁶ Both actions indicate that those institutions passed their stress tests. However, unlike in April 2009, the Fed has not released the stress test results publicly – and, in fact, has instructed banks not to reveal their individual results.

We continue to believe that the Dodd-Frank and Basel III regulatory changes will be positive for investors in preferred securities. Banks will need to hold significantly more common equity capital than they have in the past. In fact, they already do. This will give banks much more capacity to absorb losses before preferred investments are in danger of impairment. In addition, other regulatory changes such as the Volker Rule and derivatives clearing and reporting requirements should reduce the risk profiles at banks. While all these regulatory changes create uncertainty in the market, we think they will be beneficial for preferreds.

Flaherty & Crumrine Incorporated
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⁵ BBT, BK, C, JPM, KEY, STT, USB, and WFC announced dividend increases as of the second quarter of 2011.

⁶ KEY and STI raised \$650 million and \$1 billion, respectively, in common equity and will repay TARP.

Basel III Capital Requirements

Annex 4

Phase-in arrangements

(shading indicates transition periods - all dates are as of 1 January)

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | As of 1 January 2019 |
|--|---------------------------|------|---|------|----------------------------|--------|-------|----------------------------|----------------------------|
| Leverage Ratio | Supervisory monitoring | | Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015 | | | | | Migration to Pillar 1 | |
| Minimum Common Equity Capital Ratio | | | 3.5% | 4.0% | 4.5% | 4.5% | 4.5% | 4.5% | 4.5% |
| Capital Conservation Buffer | | | | | | 0.625% | 1.25% | 1.875% | 2.50% |
| Minimum common equity plus capital conservation buffer | | | 3.5% | 4.0% | 4.5% | 5.125% | 5.75% | 6.375% | 7.0% |
| Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials) | | | | 20% | 40% | 60% | 80% | 100% | 100% |
| Minimum Tier 1 Capital | | | 4.5% | 5.5% | 6.0% | 6.0% | 6.0% | 6.0% | 6.0% |
| Minimum Total Capital | | | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% |
| Minimum Total Capital plus conservation buffer | | | 8.0% | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital | | | Phased out over 10 year horizon beginning 2013 | | | | | | |
| Liquidity coverage ratio | Observation period begins | | | | Introduce minimum standard | | | | |
| Net stable funding ratio | Observation period begins | | | | | | | Introduce minimum standard | |