Flaherty & Crumrine Incorporated

Preferred Market Update

Summary

- We anticipate modest economic growth with diminishing inflation in the United States.
- The European sovereign debt crisis needed to get worse in order to get better. It got worse, and policymakers finally appear to be moving toward a comprehensive solution. We are optimistic that the situation will soon begin to improve.
- Although some regulatory uncertainty has been resolved, the bank capital rules required by Dodd-Frank financial reform legislation have yet to be announced. Basel regulators set a 1.0-2.5% additional common equity capital requirement for systemically important banks.
- Credit conditions continue to improve fundamentally, though credit spreads have widened and preferred prices have fallen in recent months.
- We see good value in preferred securities, which can sustain Depression-era default rates and still provide attractive long-term returns.

Economic Outlook

U.S. economic growth improved in the third quarter following surprisingly slow growth in the first half of 2011. The growth outlook for the remainder of this year and next year remains modest, however, and risks to the economy abound.[1] Growth in inflation-adjusted Gross Domestic Product (real GDP) averaged just 0.8% in the first half of 2011, in part due to headwinds from higher oil prices from supply shocks in the Middle East and global supply chain disruptions from the tragic earthquake and tsunami in Japan. With those headwinds now receding, real GDP growth is expected to accelerate to 2.2% in Q3, 2.6% in Q4, and then hold steady at 2.6% for all of 2012.[2] Although growth in the 2½ percent area is slow for a "typical" recovery from recession, it should be fast enough to accommodate ongoing household and financial sector deleveraging and balance sheet improvement. It also should keep new issuance of preferred securities relatively light. We see this as a fundamentally constructive environment for preferreds.

The major risk to that relatively benign outlook is the sovereign debt crisis in Europe. The financial press has written extensively on the problems in Europe, and we will not recite them here, nor will we offer yet another prescription for a solution to the crisis. From our perspective as preferred investors, we see two recent painful but ultimately positive developments that seem likely (finally) to push policymakers into crafting a comprehensive solution to the crisis. First, markets over the third quarter lost patience with the piecemeal actions previously taken by European policymakers. Sovereign debt spreads widened in non-core Eurozone countries (i.e. Portugal, Ireland, Italy, Greece, and Spain – PIIGS). Of particular concern, yields on Spanish and Italian bonds rose sharply, threatening to push the crisis into much larger economies than those previously afflicted. Those pressures prompted policymakers to agree in July to an expansion of

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[1] For a detailed explanation of our economic views, see *Third-Quarter U.S. Economic Update*, Flaherty & Crumrine Incorporated, October 2011, available at www.preferredincome.com, www.flaherty-crumrine.com, or www.fcclaymore.com.

[2] All growth rates are annualized unless noted otherwise. Economic forecasts in this Update are from *The Survey of Professional Forecasters*, Federal Reserve Bank of Philadelphia, August 12, 2011.

the European Financial Stability Facility (EFSF), an agreement that eventually was passed by all 17 EMU members last week. Second, policymakers recognized that the sovereign debt crisis has also become a banking crisis, given the sizable holdings of sovereign debt at European banks. They are now developing plans to recapitalize banks that will need additional capital. These steps are necessary to prepare the market and the Eurozone economy for the inevitable default by Greece on its sovereign debt.

We view these developments as painful but ultimately positive because things needed to get worse to drive policymakers to adopt unpopular but necessary measures – and that's exactly what happened. Governments across the Eurozone have (to varying degrees) imposed fiscal austerity measures that would have been impossible in the absence of a worsening crisis. Moreover, they are beginning to implement productivity-enhancing structural changes to their economies that should lead to stronger economic growth when recovery takes hold, which is the key to long-term fiscal sustainability. Budding efforts to support the banking system should allow lending to continue without disrupting the recovery process. This more comprehensive approach to the crisis – preparing to allow for a Greek default while building a bridge to stronger future growth in the Eurozone – is a major and welcome change from earlier "finger in the dyke" exercises to keep troubled economies afloat. Although many details still need to be worked out, we are now optimistic that the crisis is moving in a positive direction.

Regulatory Update

There has been only limited progress in recent months on the two major regulatory efforts affecting 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). Starting with Basel III, the only major development since last spring is the finalization of the additional capital requirement for global systemically important financial institutions (SIFIs). The Basel Committee decided that SIFIs will need to hold an additional 1.0-2.5% of *common equity* capital over and above Basel III minimum requirements; the amount within that range will depend upon the bank's size, global interconnectedness, and systemic importance. In addition, the Committee reserved an extra 1% common equity requirement that might be applied if a bank becomes even more systemically important in the future. The Committee will publish its criteria for identifying SIFIs and determining the appropriate capital buffer (between 1.0-2.5%) by March 2012.

Turning to Dodd-Frank, we are still waiting for the Fed's proposed bank capital rules, which were due in the third quarter and begin to take effect in January 2013. It now appears that the Fed will publish its proposal late this year or early next year, which means final rules probably will not be promulgated until the end of 1Q2012 at the earliest. In the meantime, both bank issuers of preferred securities and investors in them will be left to guess what the final regulations will look like. We already know that trust preferred securities (TruPS) will no longer fully qualify as Tier 1 capital for bank holding companies beginning in January 2013, with full phase-out by January 2016.[3] However, we do not know what other type(s) of preferred securities will qualify as Tier 1 capital. We (and most of the market) believe that perpetual, non-cumulative, non-step-up

[3] These TruPS rules apply to banks with more than $15 billion in assets as of December 31, 2009. Smaller bank TruPS issued prior to May 19, 2010 will continue to qualify as Tier 1 capital. The phase-out 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.

preferred securities eligible for the dividends-received deduction (i.e., traditional preferred stock) will continue to qualify as Tier 1 capital in the U.S., but it is unclear if any other preferreds will qualify.

On one hand, this regulatory uncertainty has limited the amount of new issue supply in the preferred market, as banks cannot be sure that preferred stock issues sold today will qualify as Tier 1 capital in 2013 and beyond. There have been a handful of new issue bank preferreds this year, but they have tended to be opportunistic issues (i.e., done at a time when financing costs were considered attractive by the issuer). We continue to expect limited supply until the capital rules are clarified.

On the other hand, regulatory uncertainty has not prevented issuers from redeeming TruPS that are expensive in today's low-yield environment. Wells Fargo, Fifth Third Bancorp, Sovereign Bank, Barclays, HSBC, Keycorp, and US Bank are among the issuers that have called TruPS since the end of the first quarter. Some of these calls have been pursuant to their normal call provisions, and others have made use of regulatory call provisions. We anticipate that many more (but not all) TruPS will be called when the Fed issues its bank capital rules, which will qualify as a "regulatory capital event" allowing certain issues to be called at par. Which issues get called and which remain outstanding will depend upon both the terms of each issue and the capital costs and requirements of each issuer. It's going to be an interesting period.

On balance, 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. 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 near-term uncertainty in the market, we think they will be beneficial for preferreds in the long run.

Credit Outlook

Credit quality in the U.S. continues to improve, albeit at a slower pace than last year given the slowdown in the economic recovery. Corporate profits as a percentage of GDP are at record 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 at the lowest level since the mid-1960s. The corporate "financing gap" (corporate financing needs less internally generated funds) remains negative. 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 2012, although the pace of improvement is likely to slow from the earlier days of the recovery.

Households also continue to make progress deleveraging their balance sheets. Mortgage debt is shrinking rapidly while consumer credit is barely edging higher. Household financial obligations ratios (the proportion of disposable income devoted to debt service, auto and apartment leases, homeowners' insurance, and property tax payments) are declining and are now back to levels last seen in the mid-1990s. In fact, these broad measures of financial obligations are not too far from where they were in the early 1980s, shortly before the 25-year rise in household debt took root.

Consistent with this constructive macroeconomic credit view, credit trends in the major sectors of the preferred market also are improving. Problem loans at banks are falling, with both new delinquencies and charge-offs declining. While that improvement may pause given the recent slowdown in economic growth, we do not think it will worsen materially, and it should reaccelerate with stronger growth next year. Earnings at banks continue to recover from the financial crisis, although here too the pace of growth is likely to slow given (1) pressure on net interest margins from sluggish loan growth and low interest rates and (2) rising costs of regulatory compliance and, for some banks, mortgage-related litigation.

Insurance company credit fundamentals remain healthy and business volumes generally have remained good. Property and casualty (P&C) companies have had to pay sizable claims on recent natural disasters, leading a number of them to announce third-quarter losses. However, their balance sheets are very strong (even after taking catastrophe claims into account), and P&C premiums are rising, which should help companies regenerate capital in the future. Life insurance companies are facing some earnings stress and balance sheet volatility, but most have comfortable capital cushions and solid earnings streams that can weather those near-term headwinds.

Electric utilities have been an anchor of stability in recent years. While sales volumes are growing a little more slowly than expected due to sluggish economic activity in the first half of the year, balance sheets are strong and earnings are rising modestly on incremental (but rarely transformational) capital expenditures. As preferred investors, we are delighted with strong fixed-charge coverage and 9-10% return on equity, which is what we see at a number of utilities.

Other sectors, including real estate investment trusts, pipeline, energy, and industrial companies show similar stable or improving credit profiles. This does not mean that all companies are performing equally well, of course – that's why we do credit analysis. But it does indicate that the operating environment for most preferred issuers (with Europe being a notable exception) is reasonably good.

Preferred Market Performance

Despite these positive fundamental credit trends, credit spreads widened sharply in the third quarter. The Moody's long Baa-rated corporate spread to Treasuries widened by 79 bp, and high yield spreads widened by 342 bp. Preferred securities prices fell. The Bank of America – Merrill Lynch preferred indices fell in price by 1.8-6.5% during the third quarter, on average their worst quarterly performance since the first quarter of 2009.[4]

Trading volumes for most preferred securities have declined recently, but by most measures the markets remain healthy. Flows tend to be "lumpier" indicating an increase in institutional trades along with a drop in retail activity. Price volatility remains stubbornly high for the traditionally sleepy preferred market. We expect this will persist over the near term as investor memories of the extreme price swings during the financial crisis are still fresh.

We believe that three main investor worries caused the poor performance of preferreds. First, the U.S. economy slowed in the first half of the year, but much of that weakness was not visible in the economic data until downwardly revised GDP was reported in late July. The weak data raised fears of renewed recession, deteriorating loan quality, and heightened sovereign risk.

[4] As of today, the prices of these indices are about unchanged from quarter-end.

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Second, as described earlier, the European sovereign debt crisis worsened materially in the third quarter. Faced with deepening recessions, Greece and Portugal struggled to meet their budget deficit targets and had to enact further austerity measures. Yields on Spanish and Italian government bonds rose significantly. Meanwhile, European leaders moved only slowly toward a solution to the crisis. Given their sizable aggregate exposure to sovereign debt, many European financial institutions face potentially large losses if sovereign defaults spread beyond Greece, raising the risk of financial contagion.

Finally, regulatory uncertainty left financial companies unsure of what capital instruments are appropriate for dealing with capital inadequacies. More importantly, it left investors unsure of what will happen to preferred securities if a company requires state support. Basel III imposes requirements for loss absorption on preferred securities before the provision of state aid, but Basel III has not yet been adopted, and policymakers have indicated that existing regimes for state support remain intact. As a result, it is impossible to generalize about which banks might receive state support, what form it might take, and what will happen to outstanding preferred securities if they do. These worries combined to send preferred investors to the exits.

We believe these concerns, while real, have gone too far. First, economic growth should improve in the U.S. after its poor performance in the first half of 2011. We do not expect strong growth, but we also do not expect recession, which should allow for the positive credit trends we have outlined to continue. Although recession is inevitable in Eurozone countries that require a large dose of fiscal austerity, resolution of the sovereign debt crisis should set the stage for significantly stronger growth in the region. Second, European policymakers finally appear to be moving credibly to contain the crisis. Many European banks will need to be recapitalized, which should avert financial contagion and give countries more time to reduce their budget deficits and implement structural reforms to boost economic growth. It is likely that some banks will need such large amounts of state support that they will be forced to impose losses on their preferred capital providers. We do not, however, expect that all European banks will need state support, and in any event, we do not currently anticipate that losses will be imposed on preferred capital providers at any bank in our portfolio.

Preferred Valuation

Given the pullback in preferred prices since the end of June, we decided to revisit the breakeven default analysis we developed during the financial crisis.[5] The questions we try to answer are (1) how bad do defaults on preferreds have to be to earn either a zero return or a return equal to Treasuries over a 10-year investment horizon and (2) what would returns look like if default experience turns out to be as bad as it was during the Great Depression? The table below summarizes the results of that analysis.

[5] For a full description of the model, see *Preferred Valuation After the TARP*, Flaherty & Crumrine Incorporated, January 2009; available at www.preferredincome.com, www.flaherty-crumrine.com, or www.fcclaymore.com.

Before discussing the results, we will quickly review the model that we use. We start with current prices and yields on three Bank of America – Merrill Lynch preferred indices, the 8% Capped DRD-eligible preferred stock index (P8D0), the 8% capped hybrid preferred securities index (P8HO), and the 8% capped corporate U.S. capital securities index (C8CT). We then apply a quarterly default rate to the index, assuming no recovery upon default and no deferrals[6], over our 10-year investment horizon and calculate the internal rate of return on those cash flows. We then compare that IRR with the 10-year Treasury rate. We assume that defaults will run high for the first two years, declining by one-half each year for the next four years, and stabilizing at 0.25% per year in the final four years of our 10-year investment horizon. (The default rate of 0.25% per year represents the average default experience on Moody's investment grade credits from 1994-2007.) This default profile – high initially and gradually declining to a long-term average – is designed to represent defaults during a crisis period. Of course, we don't expect a crisis, but this exercise is intended to see how preferreds might perform in a stress scenario, not to derive an expected return on preferred securities.

Date:	**10/14/2011**	***Ten-Year Breakeven Default Analysis (Fast-Normal Default Model)***				
BoA/Merrill 8% Capped DRD-Eligible Preferred Stock Index (P8D0). Starting Price = 100.05, Annualized Portfolio Yield = 6.92%						
Starting Default Rate	Cumulative Defaults	Ending Price	Ending Current Yield	Preferred IRR	Sprd to UST 10-yr (bp)	Scenario Description
18.73%	43.5%	100.05	6.91%	0.00%	-224	Zero Return
12.60%	32.0%	100.05	6.91%	2.24%	0	Breakeven to UST 10-yr
15.69%	38.0%	100.05	6.91%	1.11%	-113	Bank default rate in Great Depression
10.73%	28.0%	100.05	6.91%	2.93%	69	Default rate for all rated bonds in Great Depression
3.31%	10.2%	100.05	6.91%	5.73%	349	Default rate for Baa-rated bonds in Great Depression
3.31%	10.2%	100.00	6.92%	5.73%	349	Same as above, but average ending price drops to 100% of par
BoA/Merrill 8% Capped Hybrid Preferred Securities Index (P8HO). Starting Price = 97.37, Annualized Portfolio Yield = 7.15%						
Starting Default Rate	Cumulative Defaults	Ending Price	Ending Current Yield	Preferred IRR	Sprd to UST 10-yr (bp)	Scenario Description
19.69%	45.1%	97.37	7.34%	0.00%	-224	Zero Return
13.62%	34.0%	97.37	7.34%	2.24%	0	Breakeven to UST 10-yr
15.69%	38.0%	97.37	7.34%	1.47%	-77	Bank default rate in Great Depression
10.73%	28.0%	97.37	7.34%	3.32%	108	Default rate for all rated bonds in Great Depression
3.31%	10.2%	97.37	7.34%	6.16%	392	Default rate for Baa-rated bonds in Great Depression
3.31%	10.2%	100.00	7.15%	6.36%	412	Same as above, but average ending price recovers to 100% of par
BoA/Merrill 8% Capped Corporate US Capital Securities Index (C8CT). Starting Price = 94.22, Annualized Portfolio Yield = 7.17%						
Starting Default Rate	Cumulative Defaults	Ending Price	Ending Current Yield	Preferred IRR	Sprd to UST 10-yr (bp)	Scenario Description
20.28%	46.1%	94.22	7.61%	0.00%	-224	Zero Return
14.25%	35.3%	94.22	7.61%	2.24%	0	Breakeven to UST 10-yr
15.69%	38.0%	94.22	7.61%	1.70%	-54	Bank default rate in Great Depression
10.73%	28.0%	94.22	7.61%	3.57%	133	Default rate for all rated bonds in Great Depression
3.31%	10.2%	94.22	7.61%	6.44%	420	Default rate for Baa-rated bonds in Great Depression
3.31%	10.2%	100.00	7.17%	6.87%	463	Same as above, but average ending price recovers to 100% of par

The first two scenarios for each index show the default rates (for the initial 2-year "high default" period and cumulative defaults over the 10-year horizon) required to generate an IRR of zero or an IRR equal to the 10-year Treasury yield, assuming prices on preferred securities are unchanged at the end of the 10-year horizon. The next three scenarios apply various default rates that reflect actual cumulative default rates experienced during the Great Depression. From the end of 1928 to the beginning of 1939, approximately 38% of depositary institutions failed. Over the same 10-year period, 28% of all bonds (including speculative grade) rated by Moody's Investors Service defaulted, while 10.2% of Baa-rated bonds defaulted. The final scenario is the same as the "Baa" scenario, but we assume that average preferred prices return to par in 10 years.

[6] Although dividend deferral happens infrequently, it does happen, and it is a risk that the model does not incorporate. We attempt to compensate for this by making the conservative assumption that recovery upon default is zero, whereas the historical recovery rate on defaulted preferreds, according to Moody's Investors Service, is approximately 13% of par. Nonetheless, a high rate of dividend deferral would reduce the breakeven default rates generated by our default model.

The table reveals that to earn a zero return, defaults on the preferred indices would have to be even higher than the failure rate of banks during the Great Depression. It also shows that default rates would need to exceed those for all bonds during the Depression (including junk) to earn the same return as on the 10-year Treasury. Even if defaults occur at the rate that Baa-rated securities experienced during the Depression, the preferred indices outperform Treasuries by 3.5-4.6% per annum in this analysis. We are more sanguine. While we know there will be some defaults and deferrals over the next decade, we do not think they will be as bad as they were during the Great Depression. We see good value in preferreds today.

Flaherty & Crumrine Incorporated
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