



## Special Report: 2008 – A Troubling Year for TruPS CDOs

### Summary

The financial turmoil continues to take its toll on the roughly \$60 billion trust preferred CDO market.

#### AUTHOR:

Gene Phillips  
Director  
212.918.4944  
[gene.phillips@pf2se.com](mailto:gene.phillips@pf2se.com)

Increasing distress in the banking sector<sup>1</sup> and the deepening credit pressures facing the real estate sectors have plagued trust preferred securities (TruPS) issuers, and manifested in the number of issuer defaults and deferrals (and credit risk sales) suffered by TruPS CDOs.

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Primarily exposed to bank and insurance-issued TruPS -- and to a lesser extent real estate investment trust (REIT) TruPS<sup>2</sup> -- the future performance of the TruPS CDO asset class as a whole depends heavily on the performance of the financial sector and, with it, the uncertainties surrounding the length and depth of, and the recovery from, the economic recession we recently entered.

In turn, the outcome of these macroeconomic “uncertainties” is largely dependent on the execution of current and future government intervention initiatives. Essentially, the question remains: *how effective will the incoming administration be in promoting stability and injecting liquidity into the mortgage market?*

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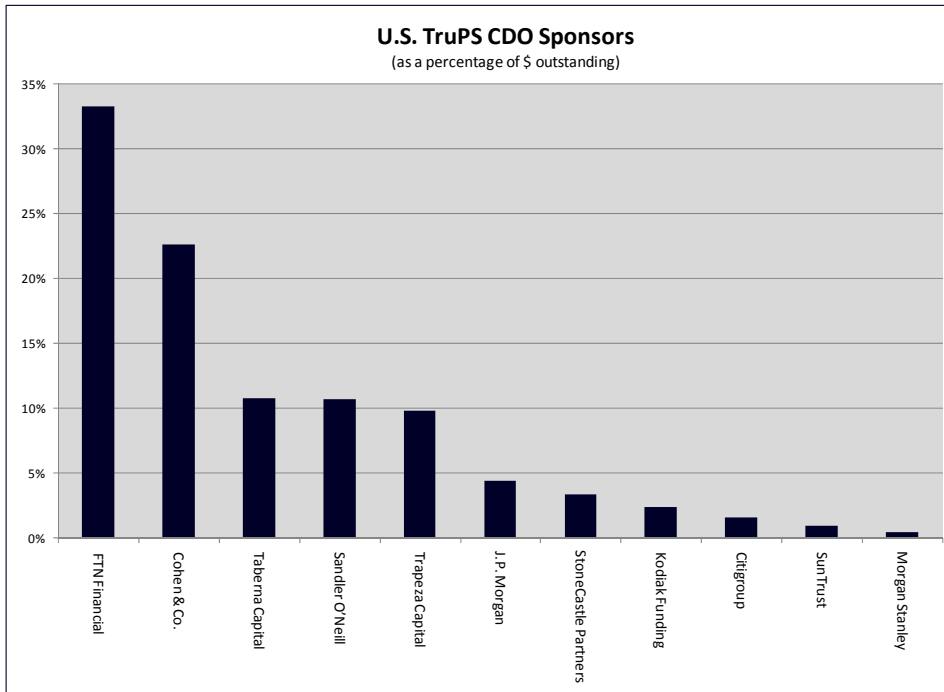
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<sup>1</sup> To highlight this distress, 25 FDIC-insured banks defaulted in 2008 – 21 of which defaulted in the second half of the year -- versus 27 *cumulatively* for the previous eight years (2000-2007). At the time of writing, three FDIC-insured banks have failed in 2009.

[www.fdic.gov/bank/individual/failed/banklist.html](http://www.fdic.gov/bank/individual/failed/banklist.html).

<sup>2</sup> We broadly include real estate-related exposure, such as homebuilder issuance, under the REIT classification throughout this report.

## The TruPS CDO Market



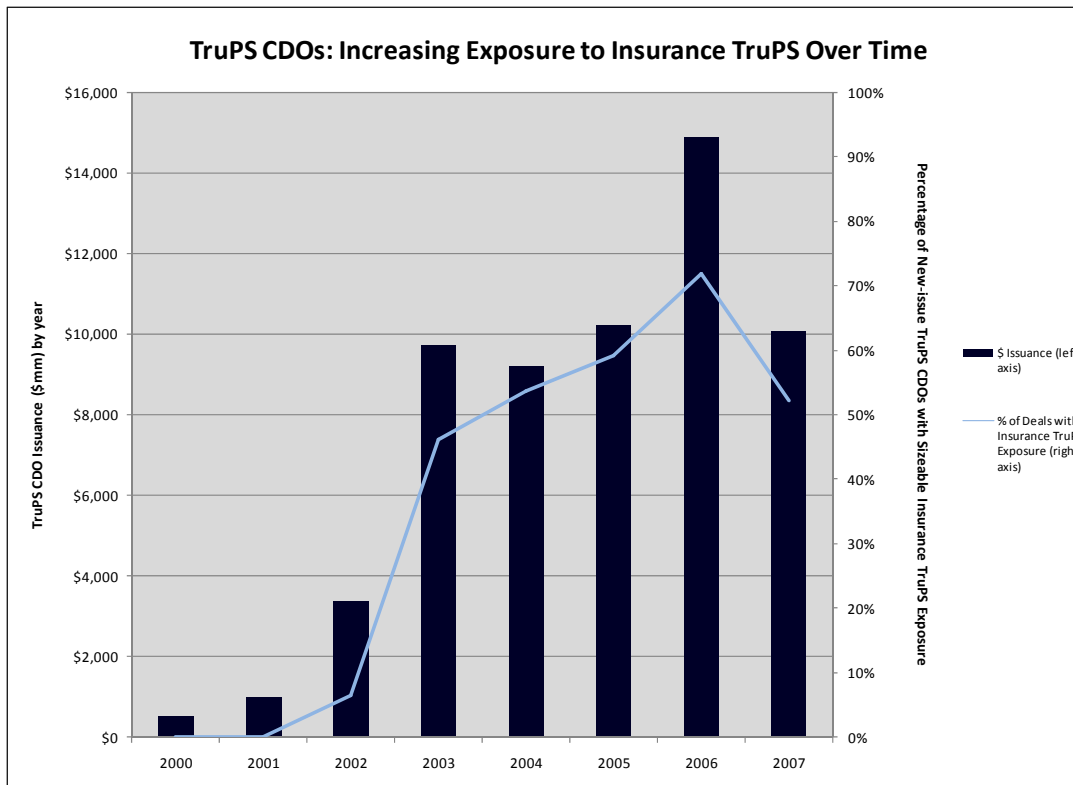
*Left:* TruPS CDOs issuance has been largely centered around a handful of sponsors and issuer shelves with the six largest sponsors accounting for approximately 92% of current outstanding issuance<sup>3</sup> and roughly 87% of deals issued.

As the issuance market for TruPS CDOs expanded each year, from 2000 to 2006, the proportional exposure to bank TruPS decreased as arrangers sought to include other asset classes to meet investor demand.

While initially any non-bank exposure was considered to be a credit negative by investors – and indeed REIT exposure, for example, turned out to typically be disadvantageous to most deals – the insurance TruPS exposure has to this date outperformed the bank TruPS exposure, and as such has proven a credit positive for these deals. Having said that, TruPS CDOs are typically long-term transactions (at this stage unlikely to benefit from either the early optional redemption or auction call features baked into the deals) and the near-term effects of insurance exposure is likely no guarantee as to its future effects.

TruPS CDO Issuance Vintage / Classification	Exposure (\$mm)
<b>2000</b>	<b>\$ 513</b>
Bank	100%
<b>2001</b>	<b>\$ 984</b>
Bank	100%
<b>2002</b>	<b>\$ 3,361</b>
Bank	93.54%
Insurance	6.46%
<b>2003</b>	<b>\$ 9,717</b>
Bank	53.78%
Bank, Insurance	2.98%
Insurance	43.23%
<b>2004</b>	<b>\$ 9,213</b>
Bank	46.31%
Bank, Insurance	33.59%
Insurance	20.10%
<b>2005</b>	<b>\$ 10,222</b>
Bank	8.21%
Bank, Insurance	53.33%
Bank, Insurance, REIT	5.91%
Bank, Other	3.16%
REIT	29.39%
<b>2006</b>	<b>\$ 14,876</b>
Bank, Insurance	36.37%
Bank, Insurance, REIT	35.50%
Bank, Other	2.23%
REIT	25.91%
<b>2007</b>	<b>\$ 10,066</b>
Bank	12.86%
Bank, Insurance	52.20%
Bank, Other	5.42%
REIT	29.51%
<b>Total</b>	<b>\$ 58,952</b>

<sup>3</sup> This calculation is by dollar volume, as are all other calculations in this report unless indicated otherwise.



### The Year 2008, by the Numbers

Using a data set, as of December 2008, of approximately \$10.3bn – roughly 17.5% of the TruPS CDO market – we analyzed the change in performance of TruPS CDOs during 2008, as measured by the deals’ default and deferral rates and the changes in overcollateralization (OC) test ratios.<sup>4</sup>

Increasing Exposure to Deferring and Defaulted Collateral Securities in TruPS CDOs (during 2008)			
	12/2007	6/2008	12/2008
Average	1.00%	6.04%	9.06%
Median	0.00%	5.33%	9.94%

OC test ratios for TruPS CDOs typically measure the coverage of the deal’s performing collateral (i.e., the bank and insurance TruPS themselves) over the CDO’s liabilities in question. For example, a Class A/B OC test ratio would measure the coverage of the deal’s performing collateral over the outstanding par balances of the Class A and Class B notes. Since each deal may have different coverage tests, for the purposes of this analysis we examined the performances of each deal’s senior-most and junior-most O/C tests.<sup>5</sup>

<sup>4</sup> Interest coverage (IC) tests, too, are worthwhile indicators of a deal’s performance. However, IC tests are typically more volatile than OC tests and may be temporarily swayed by both the interest payment frequency profile of the deal’s underlying collateral, as well as changes in the LIBOR curve.

<sup>5</sup> Note that on a deal-by-deal basis, a rating agency-defined recovery assumption may be added for non-performing (deferring, defaulted) for purposes of inclusion in the OC test numerator. Given their subordinated positioning in the capital structure, TruPS are often assumed to carry low recovery rates, often in the 5% to 10% region.

TruPS CDO deals' OC ratios were understandably hampered by the interest deferral, and subsequently default, of underlying issuers during 2008: having started the year with almost all senior-most OC ratios intact, and only slightly more than 10% of junior-most OC ratios tripping their triggers, we ended the year with almost a quarter of senior-most OC tests failing, and all junior-most tests failing.

	Senior-most O/C Ratio			Junior-most O/C Ratio		
	12/2007	6/2008	12/2008	12/2007	6/2008	12/2008
<b>% TruPS CDOs Failing Trigger</b>	0%	0%	23%	11%	100%	100%
<b>Overall % Change (since initial)</b>						
Average	-0.70%	-4.99%	-7.72%	-0.92%	-5.24%	-8.23%
Median	0.00%	-4.99%	-7.31%	-0.04%	-4.99%	-8.07%
<b>Annualized % Change (since initial)</b>						
Average	-0.32%	-2.35%	-3.59%	-0.39%	-2.44%	-3.82%
Median	0.00%	-1.91%	-3.11%	-0.02%	-1.98%	-3.32%

As the table above highlights, the December-end levels indicate an average *annualized* loss rate of approximately 3.6% on senior OC tests, and 3.8% on the junior tests. As of the beginning of the year, annualized loss numbers were as low as 0.3% and 0.4% for the senior-most and junior-most OC ratios, respectively.

## Closing Remarks - 2009 and Beyond

While the financial sector's difficulties have proved a burden to most if not all TruPS CDOs, there remains a need to analyze each one separately; while perhaps most TruPS CDOs are equal, some are certainly more equal than others.

Among typical collateral-specific stratifications, such as the regional or geographic concentration of the deal's underlying issuers, their exposure to home equity and their access to funding, the following remain among the key points to investigate on a deal-by-deal basis:

- indenture-defined coverage test cure mechanisms – and particularly whether OC test failures are cured sequentially or pro-rata;
- the extent to which the deal's manager can actively trade the portfolio, and potentially avoid potential defaults in the collateral; and
- whether the deal has any idiosyncratic language relating to possible early termination or callability (via optional redemption, auction call, or other features).

While the prospects may be bleak for this asset class, there remains the possibility – unlikely as it may seem today -- of a positive turnaround.

If the new administration is able to swiftly stem the tide of home price depreciation by effectively implementing its current initiatives (by way of strengthening the GSEs, to encourage lending; through facilities such as TALF<sup>6</sup> and the FHA expansion programs which assist displaced and negative equity borrowers, and reduce the motivation for deliberate borrower default; and via loan modification programs to keep homeowners in their homes) and proposed initiatives (including bankruptcy cram-down legislation to increase home purchase affordability), we may be able to effectuate a V-shaped economic recovery, which would augur well for the future of secondary TruPS CDOs.

<sup>6</sup> Term Asset-Backed Securities Loan Facility, designed to keep mortgage borrowing rates down.

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