PF2 Securities Evaluations

Special Report: TruPS CDOs - A Draconian H1 2009

Heating Inferno, With No Sign of Purgatorio

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Overview

To say the least, the positive effects of the purported economic turnaround were not to be felt by the troubled world of TruPS CDOs.

Increasing bank default and deferral rates, coupled with an historically low interest rate environment, further exhausted the thin subordination levels in these tightly-structured deals and magnified the inherent structural weaknesses of this $59 billion asset class.[1] The result: further overcollateralization trigger failures and, in two cases, the occurrence of a deal-level Event of Default.

Indeed, in a market sensitive to both the rate of change of economic data, and the second derivative thereof,[2] the TruPS CDOs' striking underperformance became all the more noticeable:[3]

- On an annualized basis, the rate of overcollateralization ("OC" or "O/C") deterioration occurred on average at roughly twice the speed for both senior-most and junior-most OC tests in H1 2009 versus in 2008 (with median rate increases of 93.3% and 74.2% for the senior-most and junior-most test levels, respectively);
- Almost one in two deals was failing its senior-most OC ratio trigger as of June-end 2009, versus approximately one in five as of year-end 2008.

[1] For a breakdown of TruPS CDO issuance, see our "*Special Report: 2008 – A Troubling Year for TruPS CDOs*," available at http://pf2se.com/pdfs/TruPS%20CDO%20Report%202008.pdf.
[2] That is, the rate of the rate of change.
[3] Referenced data is based on our sample set of roughly one quarter of the TruPS CDO market.

Bank Fundamentals and Defaults

Default rates on FDIC-insured institutions continue to climb towards the peak levels of the 1982-1994 "banking crisis," which reached 1.58% in 1988 and 1999.[4]

- From less than 0.1% of the December 31, 2007 cohort defaulting in H1 2008, approximately 0.5% of the June 30, 2008 cohort defaulted in H2 2008;[5]
- By June-end 2009, 45 FDIC-insured banks had defaulted in 2009, constituting roughly 1.1% of the December 31, 2008 cohort – a 260% increase over the default rate of 2008;[6]
- At the time of writing, a further 12 banks have defaulted since June 30, 2009, bringing the 2009 annualized default rate up to 1.24%.

More generally, FDIC-insured institutions' balance sheets and reserve levels continue to weaken, as can be seen from the increasing charge-off rates and percentages of noncurrent loans, and the decreasing coverage ratios, which measure their reserves for losses as a percentage of noncurrent loans.[7]

FDIC-insured Institutions' Performance					
	6/30/07	12/31/07	6/30/08	12/31/08	3/31/09
Net Charge-Off Rate - All Loans (QTR)	0.49%	0.84%	1.32%	1.92%	1.94%
Noncurrent Loan Rate (Total Loans)*	0.91%	1.40%	2.04%	2.93%	3.77%
Coverage Ratio	120.00%	92.63%	88.55%	75.02%	66.49%

* Nonaccruing loans and loans past due 90+ days
Source: http://www.fdic.gov/bank/statistical/index.html

TruPS CDO Features

Given the low recovery rates realized on defaulted trust preferred issuances -- due to their deeply subordinated positioning below all other debt on each borrower's balance sheet – and their low levels of subordination, TruPS CDOs performance is acutely sensitive to defaults in their underlying pools.

They were built, as an asset class, based on more than 30 years of historical default data that supported a base underlying assumption of approximately 0.4% defaults per year,[8] give or take some leeway for temporary deferrals and various other minor stresses. As such, certain of the lower-rated TruPS CDO tranches were already unable to withstand the comparatively steep default rates of 2008 alone – almost three times the base case anticipated in the structure.[9]

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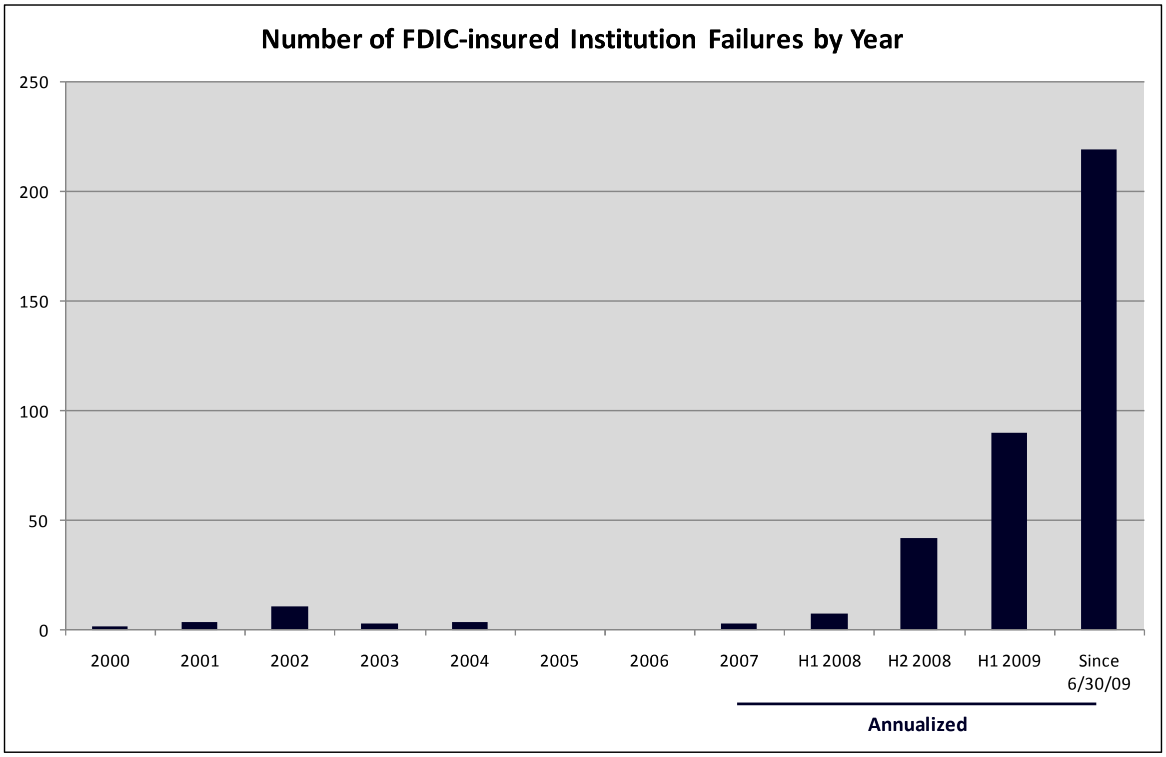
[4] See for example Citigroup's publication of July 2002, "*Historical Default Rates of FDIC-Insured Commercial Banks, 1934-2001*."
[5] Unless otherwise noted, all default rates are annualized and all references to FDIC-insured institutions include both commercial banks and savings institutions.
[6] See *www.fdic.gov/bank/individual/failed/banklist.html* and *http://www.fdic.gov/bank/statistical/index.html*.
[7] Ibid.
[8] For comparative purposes this is in the region between a Baa2 or Baa3 corporate bond default probability from Moody's. A Baa2 default probability rating is associated with a WARF of 360, which translates into a 10-year cumulative default probability of 3.6%. Annualizing this returns 0.36% per annum. A Baa3 default probability rating carries with it a WARF of 610 (0.61% per annum).
[9] Unlike certain other CDOs, TruPS CDO portfolios are typically static or, at best, lightly managed. As such, any minor excess spread generated due to outperformance in years leading up to 2008 would have "leaked out" of the deal by way of distributions to the equity note holders, and as such will typically not be reserved or made otherwise available to assist the structure through this difficult environment.



Two other economic pressures have compounded these difficulties, causing senior overcollateralization ratio failures in many TruPS CDOs and encouraging a plethora of rating agency downgrades: historically high dividend deferral rates and the low interest rate environment.

	Senior-most O/C Ratio				Junior-most O/C Ratio			
Overall % Change (since initial) *As of:*	**12/2007**	**6/2008**	**12/2008**	**6/2009**	**12/2007**	**6/2008**	**12/2008**	**6/2009**
Average	-0.49%	-4.19%	-6.76%	-12.47%	-0.74%	-4.47%	-7.13%	-12.40%
Median	0.00%	-4.17%	-6.94%	-12.19%	-0.01%	-4.83%	-7.52%	-12.47%
Annualized % Change (since initial)								
Average	-0.19%	-1.56%	-2.46%	-4.85%	-0.26%	-1.64%	-2.58%	-4.59%
Median	0.00%	-1.47%	-2.32%	-4.40%	0.00%	-1.47%	-2.43%	-4.30%

While trust preferred securities can typically defer interest payments for up to five years without being considered in default, most TruPS CDO documents require deferring securities to be considered as defaulted securities for purposes of inclusion in the OC numerator. As such, deferring securities are typically carried at only 5% or 10% of their par value in the OC test. We therefore find it constructive to examine the changing exposures in TruPS CDOs to deferring and defaulted assets, cumulatively, over time.

TruPS CDO Exposure to Deferring and Defaulted Securities				
	12/2007	**6/2008**	**12/2008**	**6/2009**
Average	0.48%	2.98%	7.10%	14.81%
Median	0.00%	5.29%	9.15%	13.99%

With TruPS CDOs already being pressured by the lack of interest generation by the defaulted and deferring securities they're holding, the additional burden caused by the deals' interest rate hedges is becoming increasingly torturous. TruPS CDOs usually have asset-level swaps (although sometimes the swap has been implemented on the deal level) that exchange a pre-negotiated fixed rate for LIBOR. With LIBOR being low, the cost of the swaps to the deal becomes tangible, on average accounting for 1.23% of the total deal portfolio size on an annual basis, or 1.45% of the performing deal size. (The median cost is 1.31% of total or 1.58% of the performing balance.)

The twin troubles of defaults and deferrals, in tandem with the not insignificant hedge costs, precipitate the increasing rate of OC deterioration.

	Senior-most O/C Ratio			Junior-most O/C Ratio		
Annualized Speed of Deterioration	**Overall 2008**	**H2 2008**	**H1 2009**	**Overall 2008**	**H2 2008**	**H1 2009**
Average	-6.41%	-5.41%	-13.54%	-6.65%	-5.84%	-12.79%
Median	-6.30%	-4.74%	-12.18%	-6.60%	-5.26%	-11.50%

Concluding Remarks

From a par coverage perspective, many of the deals are either failing or close to failing their senior coverage test triggers. While those with heavy exposures to REIT TruPS were the first to fail, the bank TruPS CDO deals are steadily following suit.

From an interest coverage ("IC") viewpoint, most TruPS CDOs – perhaps fortunately for them -- do not have IC tests. Those that do, including many of the early Taberna Preferred Funding deals, are often already failing their senior IC triggers. Their interest coverage ratios – severely depleted by defaults and deferrals, the abovementioned torturous interest rate hedges, as well as debt exchanges which have lowered the weighted average spread or coupon of the underlying portfolios – have in many cases plunged below the 100% coverage mark, which does not bode well for the deal's ability to cover future interest payments due on the senior, non deferrable notes.[10] The inability to meet interest payments on one of these "non PIKable" notes typically results in the institution of an Event of Default for the TruPS CDO deal.

To end on a hopeful, positive note (to keep our readers reading and their optimism alive) we remind you that any turnaround in the fortunes of the deferring banks – possibly due to the various forms of government intervention or otherwise – will sharply lift these deals: as it currently stands, CDO deal documents conservatively treat deferring banks as defaulted, severely "haircutting" their par amounts for purposes of inclusion in the OC numerator, typically by 90% or 95%, as may differ from deal to deal. Any collective return of deferring banks to performing banks will, thus, markedly improve TruPS CDO OC ratios.

[10] These are, typically, the originally AAA-rated notes. Unlike many other forms of CDOs, the AA-rated notes are typically PIKable, to take into account the comparatively lengthy deferrable nature of trust preferred securities.

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January 27, 2009: Special Report: 2008 – A Troubling Year for TruPS CDOs

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