



Special Report: The Tripping Point

An Initial Examination of the Bank Preferred Security Question - Shall We Defer?

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Summary

We have written extensively¹ on the state of the regional banking sector and the continued deterioration of bank trust preferred-backed CDO securities (TruPS CDOs) that results from, among other things, the increasing bank failure rate. As of the time of writing, the annualized year-to-date bank failure rate sits at approximately 1.67%.

Our discussions with bank officers, regulators and advisers have led us to consider the possibility that, whereas in 2008 most banks who deferred payments to their preference shares had little choice, many banks who began to defer in 2009 merely opted or were advised to do so – rather than being pressured or forced to defer.

This research piece, then, investigates the changing nature of the decision process by which these banks either elect or are required by their regulators to defer dividend payments to their preference shares.

While we remain at the outset of a potentially 5-year-long deferring cycle, our initial findings support the hypothesis that certain well-capitalized banks have recently elected to defer, perhaps preserving their capital for unforeseen problems ahead, or simply for a “better day.”

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¹ See for example <http://expectedloss.blogspot.com/2009/11/imperfect-hedge.html> or visit the “related research” pieces cited in the appendix to this piece.

The “Option” to Defer

One advantage of issuing preferred securities is that the issuer typically has the option of deferring payments to those securities for a period of five years without being considered to have defaulted. One caveat to deferring is that, typically, a bank will not be able to distribute any payments to any noteholders junior to the deferring preferred securities, such as common stock holders, until the preferred securities’ noteholders are made whole.²

Having said that, an important realization is that banks don’t always have the option to defer: sometimes they’re forced to defer. Many of the deferring banks are required, by way of regulatory agreements or "orders," to obtain approval prior to making any distributions on subordinated debentures or trust preferred securities. BankUnited Financial and Franklin Bank, both of which have since failed,³ are two such examples.

Some banks elected to defer of their own accord, while other banks were pressured (rather than ordered) to defer. Regulatory orders (or pressure) typically center on the bank’s regulatory capital ratio benchmarks. For example, one bank announcement reads as follows:

“On [___], 2008], the Bank announced that the Board of Directors voted to suspend quarterly dividends on its common, preferred, and trust preferred securities. Despite capital levels in excess of the regulators’ “well capitalized” benchmarks, the Board stated that it believed that the Bank would not receive the regulatory authorization to pay dividends from the Bank to [its subsidiary].”

Southport Financial Corporation, 1st Centennial Bank and Affinity Bank are examples of banks purportedly having capital levels in excess of regulatory requirements at the time they opted to defer payments. While Southport Financial seems to have remained on the right side of capitalization benchmarks levels, 1st Centennial Bank and Affinity Bank have since been pulled into receivership.

Our Modeling Approach

In this research piece we have sought to analyze the initial quality and subsequent performance of deferring banks whose preferred securities are held by one or more of a selection of sixteen trust preferred security CDOs (TruPS CDOs).

Our analysis initially measures the quality at the time at which they first decide (or are required) to defer distributions, and is performed irrespective of the par exposure or frequency of the banks’ preferred share exposure across the 16 TruPS CDOs we analyzed. Thus, for example, IndyMac Bank presents only a unique data point for this investigation, even though ten of the 16 CDOs in question had exposure to the bank.⁴

² Separately, it may be worth noting that TARP preferred equity typically ranks senior to, or pari passu with, all other existing bank-issued preferred securities. While TARP preferred equity dividend payments may be similarly deferred, the failure to pay dividends for six dividend periods triggers board appointment rights for the holder of the TARP preferred equity.

³ www.fdic.gov/bank/individual/failed/banklist.html

⁴ For informational purposes, the average exposure in each CDO to each deferring security was \$9.3mm. Of all banks whose preference shares were held by three or more of the 16 CDOs, IndyMac’s preference shares had the highest average exposure (\$14.6mm) followed by that of Franklin Bank’s preference shares (average exposure of \$14.2mm) across three CDOs. The ramifications of these large exposures in TruPS CDOs proved significant: the deferral and subsequent default of IndyMac in mid-2008, *alone*, caused one CDO to trip two junior overcollateralization test ratios. That deal had suffered no prior deferrals or defaults, and so the disproportionately large exposure to this one troubled bank significantly undermined the support for the CDO’s two lowest tranches. Crucially, the initial ratings on those tranches (BBB- and BB+ from Fitch) would have been higher than the ratings on IndyMac’s preference shares, at the time of the deal’s close, had these specific preference shares been rated. Essentially, the CDO tranches’ ratings were on a par with Fitch’s long-term issuer rating for IndyMac (BBB-). Moody’s and S&P did not rate these lower tranches, but rated the CDO’s senior notes – the likely reason being that their models could not support the ratings on the lower tranches, given the chunky exposures to unrated or low-quality assets in the CDO’s portfolio.

Some of the bank preferred securities underlying these CDOs are private, and are not traded in a secondary market. Many are issued directly into the trust, which in a way circumvents the necessity for them to be rated. As such, obtaining information pertaining to many financial institutions' preferred securities proved burdensome, particularly for certain of those issued by thrifts. Our analysis was therefore limited to those institutions for which we could readily obtain the levels of information necessary for our model to be viable. We have primarily relied on data reported by SNL Financial LC and Bloomberg LP, the accuracy of which we have taken for granted and have not sought to verify.

Our proprietary bank model ranks each bank on a scale from "Good" to "Average" to "Weak" to "Troubled," based on a variety of factors, including each bank's loan loss provisions, charge-offs rates, liquidity and leverage ratios, and proportional exposure to non-performing assets.

Unless otherwise stipulated, all analyses performed are using semi-annual call report data provided by each financial institution. Given that we're examining the performance of banks that deferred payments in either 2008 or 2009, we have analyzed these banks according to the most recent preceding, relevant semi-annual call report. The relevant financial reports examined, therefore, are those relating to: 12/31/07, 6/30/08, 12/31/08, and 6/30/09.

Model Accuracy

It is pertinent to remember that a model is only as good as its inputs and that the accuracy of the model depends on various external factors too. Ideally, the model would predict that all banks who have defaulted would have been classified as Troubled – the worst category – based on data elicited from the prior semi-annual call report.

Our model categorized approximately 80% of the defaulting assets in our analysis as Troubled based on the semi-annual call report immediately prior to its default.⁵ Approximately 12% were shown to be Weak, with the remaining approximately 8% categorized as Average. We explain this away for two reasons. First, the possibility exists that not all banks treat their assets in the same manner: some may either aggressively interpret the classification constructs in their reports or may intentionally or unintentionally hide certain truths. Second, not all banks that default need be in poor condition. For example, under certain circumstances, the FDIC might be incentivized to close *all* banks – including the well-capitalized banks – operating under the same under-capitalized parent (i.e., bank holding company). With the FDIC's deposit insurance fund in poor shape, it may be incentivized to exercise its cross-guarantee authority, shutting the well-performing banks in tandem with the underperforming banks as a means of helping support the fund against impending losses.⁶

Results and Conclusion

We often hear the argument made that bank deferral is a stepping-stone towards default. While the two events may be correlated – indeed deferring banks may be more likely than non-deferring banks to default – the act of deferring is neither a necessary nor sufficient condition for ensuring default. Some banks may be pulled directly

⁵ Thus, if a bank defaults at any time between January and June, for example, the analysis will be based on the prior December 31st call report data.

⁶ This was conjectured to be the case in the *Wall Street Journal's* article: "[When Bad Banks Sink Good Ones.](#)" Citizens National Bank and Park National Bank were reportedly pulled into receivership in tandem with the troubled FBOP Corporation. Both Citizens and Park National would have been considered "Average" banks according to our model, based on 6/30/09 call report data.

into receivership, and hence default, without ever having deferred on their preferred securities.⁷ Similarly, deferring banks may “cure” their deferrals at a later stage.

While we have little evidence of banks curing their deferrals at this early stage of the deferral cycle, the preliminary findings of our analysis contemplate the possibility that well-positioned banks, too, are more recently electing to defer.

On examining all banks in these TruPS CDOs to begin deferring distributions in either 2008 or 2009, we noticed a mild pattern that suggests an increased tendency in 2009 for Good banks to elect to defer, while fewer of the deferring banks were strictly Troubled, particularly in the second half of 2009.

Quality / Time of First Deferral	H1 2008	H2 2008	H1 2009	H2 2009
Good	0.0%	0.0%	2.9%	4.5%
Average	37.5%	25.0%	35.3%	18.2%
Weak	37.5%	41.7%	38.2%	68.2%
Troubled	25.0%	33.3%	23.5%	9.1%

Notably, this progression occurred despite the overall deterioration of banks’ credit quality over this time. We examined the quality of all deferring banks in our data set throughout the period of our study, irrespective of the timing of each bank’s initial election to defer. While more than 80% of those banks who initially deferred in either 2008 or 2009 were ranked Good or Average based on 12/31/07 call report data, less than one quarter would be similarly categorized based on 6/30/09 financials. Almost one in six of these banks defaulted before sending in 6/30/09 financials, and more than 30% of the initial subset has defaulted at the time of writing.

Quality / Call Report Date	12/31/07	06/30/08	12/31/08	06/30/09
Good	22.50%	12.50%	5.00%	3.75%
Average	58.75%	40.00%	30.00%	18.75%
Weak	15.00%	33.75%	37.50%	35.00%
Troubled	3.75%	12.50%	20.00%	26.25%
Defaulted	0.00%	1.25%	7.50%	16.25%

Further to this point, it is worthwhile noting an additional, tentative early reading that supports the argument that the dynamic of 2009-cohort deferrers differs from that of the 2008-cohort. As the table below shows, all of the issuers in our study who first deferred in the first half of 2008 were likely poor-quality banks: all have since defaulted. Additionally, more than one third of these banks had defaulted by the end of 2008; in contrast, fewer than 15% of issuers who first deferred in H1 2009 have, at the time of this report, defaulted. There are, however, three precious weeks remaining in 2009.

Deferred / Defaulted	H1 2008	H2 2008	H1 2009	H2 2009*	Performing
H1 2008	12.5%	25.0%	37.5%	25.0%	0.0%
H2 2008		0.0%	16.7%	33.3%	50.0%
H1 2009			8.8%	5.9%	85.3%
H2 2009				9.1%	90.9%

* As of the time of writing - numbers are subject to increase through the remainder of 2009.

⁷ This situation occurred with respect to approximately 8.6% of the defaulting banks in our study.

In sum, while data remain scarce for the illiquid, opaque world of bank trust preferred securities in TruPS CDOs, our preliminary analyses tend to support the theory that not all deferring banks are poorly positioned, under-capitalized institutions. As we monitor the situation and continue to gather further evidence to either support or reject this argument, we eagerly anticipate a conclusion that not all deferring banks are doomed to fail.

RELATED CDO RESEARCH (available at www.pf2se.com)

August 25, 2009: [CLO CCC Buckets – Key Variations in Terms and Performance](#)

July 22, 2009: [TruPS CDO Report H1 2009](#)

May 26, 2009: [Collateral Managers and Takeover Opportunities – Examining CLO Fee Structures](#)

February 11, 2009: [The Corporate Loan & CLO Conundrum – Investigating their Covenants](#)

January 27, 2009: [2008 – A Troubling Year for TruPS CDOs](#)

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