PAM Global Investments

Research

Preferred Shares and Perpetual Debt

11 February 2009

Introduction

Investors in preferred shares and related hybrid capital instruments face six major risks:

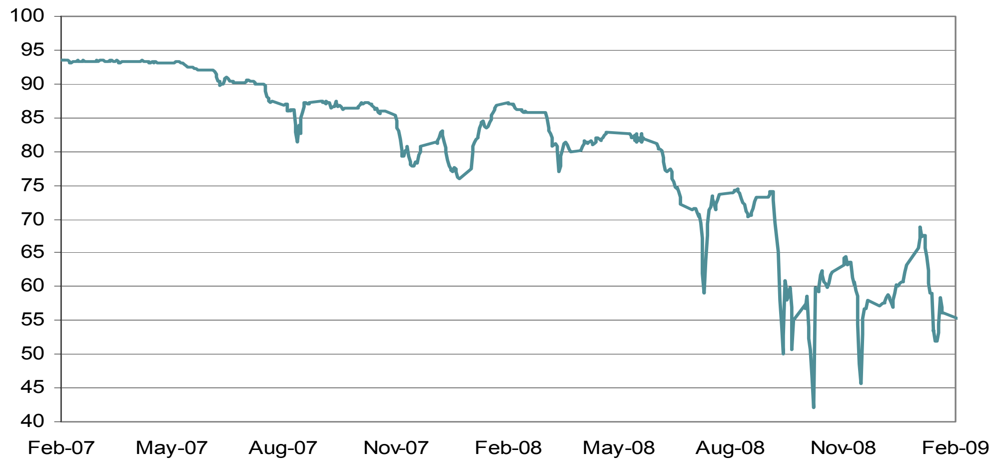
- **Bankruptcy risk**: preferred shareholders could be completely wiped out (e.g Lehman Brothers).
- **Nationalisation risk**: preferred shares may be acquired by the government with little or no compensation to shareholders (e.g. Northern Rock).
- **Dividend deferral/suspension risk**: depends on financial health of issuer, but is a particular concern at the moment for those entities that have received government capital injections and/or other forms of state support (e.g. Freddie Mac and Fannie Mae where the US Treasury mandated the suspension of preferred dividends when it placed the two entities into 'conservatorship').
- **Extension risk**: resulting from any decision not to exercise call options with a view to preserving capital.
- **Conversion/substitution risk**: some hybrid securities have provisions allowing them to be converted into non-cumulative preference shares (e.g. Lloyds TSB).
- **Downgrade risk**: rating agencies may adopt a more aggressive approach in rating preferred shares and perpetual debt which could lead to downgrades to speculative grade, resulting in forced selling from investment-grade investors (e.g. RBS, whose hybrid capital issues have been downgraded from BBB to BB).

All these risks have increased notably as a result of the credit crunch, leading to sharp and generalised declines in the prices of preferred stocks and hybrid securities (see graph).

However, the past performance and future prospects for these securities differ not just in terms of issuers but also as regards the specific characteristics of the instrument in question. Investment recommendations must hence be made on a case-by-case basis, taking into account not just the financial position of the issuer but also the precise location of the security in the issuer's capital structure. Indeed, even in the case of full nationalisation, some preferreds/hybrids could continue to be serviced if they are considered to be part of 'debt' rather than 'equity'.

In this report we review a number of widely-held preferred shares and perpetual securities.

Merrill Lynch Preferred Stock and Hybrid Securities Price Index



Securities Covered and Investment Recommendations

BAC Capital Trust II 7% 2032 Callable Cumulative Capital Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Citigroup Capital XX 7.875% Enhanced Trust Preferred Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Deutsche Bank 7.6% Trust Preferred Perpetual Securities	Hold
Deutsche Bank 8.05% Trust Preferred Perpetual Securities	Hold
Credit Suisse 7.9% Tier 1 Capital Notes	Hold
Credit Suisse 8.25% Perpetual Non-cumulative Notes	Hold
HSBC 8.125% Perpetual Subordinated Capital Securities	Hold
Barclays 8.125% Non-cumulative Callable Perpetual Preference Shares	Risk-averse investors: Sell Risk-tolerant investors: Hold
Morgan Stanley 6¼% Cumulative Callable Trust Capital Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
ABN Amro 5.9% Callable Non-cumulative Perpetual Trust Preferred Securities	Risk-averse investors: Sell Risk-tolerant investors: Hold
Allianz 8.375% Undated Subordinated Callable Bonds	Hold
ING 7.375% Callable Perpetual Hybrid Capital Securities	Hold

BAC Capital Trust II 7% 2032 Callable Cumulative Capital Securities (A-/Negative)

On January 16, Bank of America reported a loss of USD1.8bn for Q4 2008 and received emergency government funds to ease the acquisition of Merrill Lynch. The government will invest USD20bn in Bank of America in the form of preferred shares and guarantee USD118bn of assets. This support follows earlier capital injections of USD25bn in the combined company. At end-2008, the tier 1 capital ratio was 9.15%, and the government aid will boost this to about 10.7%. Nevertheless, the need for further recapitalisation cannot be ruled out. The company slashed its dividend on common stock to 1 cent per share from 32 cents in Q3.

The expectation of further capital needs is putting downward pressure on the prices of hybrid securities as it could result in deferral of coupon payments. Although the BAC Capital Trust II Cumulative Capital Securities are junior subordinated debt obligations, they rank above perpetual non-cumulative securities, including the US Treasury's preferred shares issued under the TARP programme.

Coupon payments may be deferred by the issuer for up to 5 consecutive years, but not beyond the maturity date of the Capital Securities. The issuer may call the securities on or after February 1 2007, but also has the right to extend the maturity date to no later than February 1 2051. The latter is only possible if there are no arrears on coupon payments, there is no event of default, and the subordinated notes are rated at least BBB- by S&P and Baa3 by Moody's.

At the current price of 14.6 and a YTM of 12.5%, extension risk is fully anticipated by investors as the next call date is on February 18 at the par price of 25.

Risk-averse investors should sell owing to the risk that government involvement may increase, forcing a dividend suspension to conserve capital. Risk-tolerant investors should hold, as the risk of dividend suspension is still quite limited. Given the uncertainties, no early recovery in the price is likely.

Citigroup Capital XX 7.875% Enhanced Trust Preferred Securities (BB/Stable)

Late last year, Citigroup had to be bailed out twice by the government to prevent it from failing. On October 14, the bank received a USD25bn capital injection in the form of preferred shares. Then on November 23 it received a further USD20bn in capital in the shape of preferred shares along with a guarantee to limit losses on USD306bn of toxic assets, for which the government will receive a fee of USD7bn in preferred shares.

The government preferred shares rank equal with existing Citi perpetual preferreds, but are cumulative whilst the existing shares are non-cumulative. This means the government could order a dividend suspension but still get the money back for taxpayers when dividend payments are resumed, but the private holders would lose all of the deferred interest.

The Capital XX 7.875% Enhanced Trust Preferreds are cumulative, which means that they rank higher than the perpetual preferreds. At the current price of around 11.60 (issue price 25.00) they have a YTM of 17.4%.

Risk-averse investors should sell owing to the risk that government involvement may increase, forcing a dividend suspension to conserve capital. Risk-tolerant investors should hold, as the risk of dividend suspension is still quite limited. Given the uncertainties, no early recovery in the price is likely.

Deutsche Bank 7.6% and Deutsche Bank 8.05% Trust Preferred Perpetual Securities (A-/Stable)

According to the prospectus for the **Deutsche Bank 7.6% and the Deutsche Bank 8.05% Trust Preferred Securities**, the issuer may exercise a right, at any time and on one or more occasions prior to 2013, to require the trust and the company to change specified terms of the trust preferred securities so that they could be treated as consolidated tier 1 regulatory capital. This would result in dividend payments becoming non-cumulative rather than cumulative. At present, both securities are classified as upper tier 2, indicating that dividend payments are cumulative.

On January 15, S&P affirmed it's A+ credit rating on Deutsche Bank following the bank's announcement it suffered a net loss of EUR4.8bn in Q4 2008. Deutsche Bank stated that the loss was mainly a result of the combination of a substantial deleveraging and reduction in the trading books. Nevertheless, although Deutsche Bank succeeded in meeting its target 10% tier 1 ratio at year-end, the Q4 loss is likely to have a negative impact on the bank's capitalization. S&P stated that a further decline in capitalization would likely lead to a dilution of Deutsche Bank's stand-alone credit profile. Given Deutsche Bank's high systemic importance, this would mean that government support would be forthcoming, which would limit downgrade risk.

Current market prices for the DB preferreds reflect the risk that Deutsche may convert the securities into non-cumulative preferreds. The risk of dividend suspension seems remote as Deutsche has declared a dividend on common stock, which is junior to (trust) preferred shares, of EUR0.50 per share on February 2. Consequently, **we currently recommend that investors hold the Trust Preferred Securities, but should look to sell if the Bank's financial situation deteriorates further**.

Credit Suisse 7.9% Tier 1 Capital Notes and Credit Suisse 8.25% Perpetual Non-cumulative Notes (A-/Stable)

The Credit Suisse 7.9% Tier 1 Capital Notes are perpetual junior subordinated securities. Coupon payments on the notes are not cumulative. The issuer has the right to call the notes (upon approval by the Swiss Federal Banking Commission) on or after March 28 2013. The junior subordinated status implies that the notes rank senior only to equity.

The Credit Suisse 8¼% Perpetual Non-cumulative Notes have a junior subordinated ranking and are issued by Claudius Limited, a company with limited liability incorporated in Jersey. The issuer was incorporated to issue notes and purchase collateral to secure its obligations under such notes on a limited recourse basis. This collateral consists of participation and/or preferred securities issued by Credit Suisse. Coupon payments on the Credit Suisse 8¼% Perpetual Non-cumulative Notes are paid from dividend receipts on the participation and/or preferred securities. If the issuer does not receive any dividends, then the coupon payments on the notes will not be payable, nor accumulate. The notes are callable on 27 December 2013, or any date thereafter, at a price of 100.

On 11 February, Credit Suisse announced a larger-than-expected Q4 2008 net loss of CHF6.0bn, driven by a CHF7.8bn loss in the group's investment banking unit. Even adjusting for write-downs of CHF3.2bn and gains on Credit Suisse's own debt of CHF1.9bn, underlying results in investment banking were poor at a negative CHF6.5bn. Equity sales and trading losses amounted to CHF2.2bn, while fixed income sales and trading reported losses of CHF2.9bn. Nevertheless, Credit Suisse stated that exposure to risky assets have been reduced to USD163bn as of end-2008 from USD193bn in Q3 2008, and is expected to decline further to USD135bn by end-2009. Also, Credit Suisse cut the headcount to 19,700 from 21,300 and said it is on target to further reduce it to 17,500 by year-end. The bank said that private banking continues to show solid operating performance with net income before taxes of CHF876mn. Client inflows in Wealth Management amounted to CHF13.8bn but this was largely offset by deleveraging of client portfolios of CHF11.8bn, resulting in new assets of CHF2bn. Credit Suisse's capitalization remained very strong, with a tier 1 ratio of 13.3% as of end-2008. Credit Suisse announced it will propose a cash dividend on common stock of CHF0.10 at the Annual General Meeting on April 24.

S&P lowered its rating on Credit Suisse to A+ from AA- on 19 December. The downgrade was part of a rating action by S&P on 12 major US and European financial institutions and reflects S&P's view of the significant pressure on future performance resulting from increasing bank industry risk and the deepening global economic slowdown. At the same time, the rating on subordinated debt was lowered to A- from A. The stable outlook reflects the rating agency's view that the risk of further material write-downs is now well within the bank's capacity to absorb losses, enhanced by the strong performance of its private banking unit and strong capitalization. The bank is considered to be of high systemic importance to Switzerland but external support is not explicitly factored into the ratings. Credit Suisse, is one of the few institutions in its peer group that has not required or received capital injections from the government.

In sum, Credit Suisse seems to be relatively well placed to ride out the global downturn. This is reflected by current market prices of the 7.9% Tier 1 Capital Notes and the 8.25% Perpetual Non-cumulative Notes, which trade at relatively low yields to maturity of 11% and 12%, respectively. **We recommend that investors hold the Tier 1 Capital Notes and the 8.25% Perpetual Non-cumulative Notes.**

HSBC 8.125% Perpetual Subordinated Capital Securities (A/Negative)

According to the prospectus for the HSBC 8.125% Perpetual Subordinated Capital Securities, the issuer may exercise a right to exchange the capital securities, subject to certain conditions, on any coupon payment on January 15, April 15, July 15 and October 15, for non-cumulative preference shares. Coupon payments on the Capital Securities may be deferred, and any deferred coupon payments may be paid only through a so-called Alternative Coupon Satisfaction Mechanism (ACSM). Such payments could only be funded using proceeds from issuing ordinary shares or tier 1 qualified alternative securities. The capital securities are callable at any time on or after April 15 2013.

At the current price of the capital securities at 20.6, with a yield of 9.9%, investors perceive the risk of coupon deferral and/or extension risk as relatively low. Although S&P and Fitch have put their ratings on HSBC (AA- and AA, respectively) on negative outlook, the bank has weathered the current market turbulence relatively well. It has been helped by its excellent funding and liquidity positions, with a deposit base of USD1.2trn as of

June 2008 and an 88% loan-to-deposit ratio as of September 2008. The tier 1 capital ratio was 8.9% as of September 2008. The bank has written off about USD30bn in credit-related assets since Q3 2007 and raised additional capital of USD4.9bn. On 19 January, HSBC denied rumours that it had sought capital support from the UK government and said that it is one of the world's most strongly capitalized banks.

We recommend that investors hold the HSBC Perpetual Subordinated Capital Securities.

Barclays 8.125% Non-cumulative Callable Perpetual Preference Shares (A/Negative)

On 9 February, Barclays reported better-than-expected H2 results with net profit up 49% y/y to GBP2.7bn, helped by one-time gains from the purchase of Lehman Brothers' assets and the sale of an insurance unit. Despite the relatively good H2, Barclays' pre-tax profit for 2008 dropped 44% y/y to GBP1.3bn. The bank recorded GBP8.1bn of credit-related write-downs last year. Although Barclays' total markdowns have been relatively low and the bank has raised GBP18.6bn of additional capital, investors have become increasingly concerned about the bank's capitalization. This has led to widespread speculation that the bank will have to turn for the first time to the UK government for additional capital. Barclays has denied these rumours and stated that it does not need to raise more fresh capital. According to the Bank, capitalization remains at levels well above the regulatory requirements, underscored by a pro-forma tier 1 capital ratio of 9.7%. The bank stated that it intends to recommence dividend payments on common stock during H2 2009.

The expectation of additional write-downs as well as an increase in impairments in the UK has led to downgrades of Barclays' credit ratings by both S&P and Fitch (from AA- to A+ and from AA to AA-, respectively). Nevertheless, although the risk of dividend suspension has increased, Barclays made a regular dividend payment of USD0.51 on the 8.125% preference shares on 15 December 2008. This indicates its recent willingness and ability to pay dividends. At the current price of 11.6 the Perpetual Preference Shares have a YTM of 17.6%.

Extension risk and risk of coupon deferral are mirrored by recent yields. **We therefore recommend risk-tolerant investors to keep on holding the preference shares. Risk-averse investors should consider selling at times when spreads narrow.**

Morgan Stanley 6¼% Cumulative Callable Trust Capital Securities (BBB/Negative)

Coupon payments on the Morgan Stanley capital securities can be deferred for up to five consecutive years but not beyond the maturity date of April 1 2033. However, the issuer has the option to extend the maturity of the securities to no later than April 2052. This is only possible if there are no arrears on coupon payments, there is no event of default, and the subordinated notes will be rated at least BBB- by S&P and Baa3 by Moody's.

The rating on Morgan Stanley's hybrid securities was lowered to BBB from A- by S&P on December 19 2008. Meanwhile, the investment bank's long-term issuer credit rating was downgraded to A from A+. The issuer rating benefits from a three notch uplift from Morgan Stanley's standalone credit profile, based on the expectation that additional government support is likely if need be owing to the investment bank's high systemic importance. Support for hybrid capital securities is less certain than for senior debt. Meanwhile, Morgan Stanley's liquidity profile has improved as a result of the availability of US government support under the Federal Reserve's Primary Dealer Credit Facility and the Term Securities Lending Facility. In addition, the bank can issue commercial paper to the Treasury under the Commercial Paper Funding Facility and issue term senior unsecured debt guaranteed by the FDIC. Moreover, Morgan Stanley has sold USD10bn of preferred stock under the Treasury's TARP, supplementing USD9bn of preferred stock issued to Mitsubishi UFJ Financial Group.

At the current price of 15.6 and a YTM of 10%, the risk of coupon deferral seems relatively low. Nevertheless, downgrade risk is present and may lead to increased selling pressure as investors will likely act in anticipation. If the hybrid securities are downgraded, a shift in investor base may result in forced selling.

We recommend investors with an average risk profile to sell the Morgan Stanley 6¾ Cumulative Callable Trust Capital Securities. Investors with an above average risk profile and long-term investment horizon should hold the securities. Nevertheless, given the uncertain earnings outlook for Morgan Stanley, no early recovery in the price is likely.

ABN Amro 5.9% Callable Non-cumulative Perpetual Trust Preferred Securities (BB+/Watch Developing)

The Callable Non-cumulative Perpetual Trust Preferred Securities were issued by ABN Amro Capital Funding Trust V, an indirect wholly-owned subsidiary of ABN Amro Bank and ABN Amro Holding through ABN Amro North America Holding Company. The sole assets of the trust are the preferred securities and the related rights under the ABN Amro Holding subordinated guarantee.

As a result of the downgrade of RBS's hybrid securities by S&P to BB from BBB on January 19, S&P also lowered the rating on the ABN Amro 6.08% Callable Non-cumulative Perpetual Preferred Securities to BB+ from BBB+. The downgrade on ABN Amro's junior subordinated debt reflects the higher medium-term risk of dividend suspension in the likely event that RBS retains some or all of these instruments in the break-up of ABN Amro, due to be completed in H2 2009. Nevertheless, the near-term risk of dividend suspension is perceived as somewhat more limited than that on RBS's junior subordinated debt given that ABN Amro Holding paid dividends on common equity in H2 2008 as part of the break-up process and the related capital redistribution among its owners. The outlook on the trust preference shares is developing; indicating that ratings may be lowered, affirmed or raised. A negative rating action could result if the junior subordinated debt issued by RBS is downgraded further. In contrast, ratings may be raised if ABN Amro were to confirm that the trust preference shares will be absorbed in the break-up by the Dutch government-owned businesses.

At the current yield of 19.7%, the market seems to have priced in coupon suspension and extension risk. The high yield may also reflect forced selling after the downgrade to sub-investment grade and may thus not be entirely driven by the expectation of outcomes such as coupon deferral. The risk of coupon deferral depends amongst other factors on whether the securities are absorbed by RBS or by the Dutch government-owned businesses. Even in the latter case, there is an outside chance that the Dutch authorities would avoid coupon deferral if this would be seen as a general undermining of public finances.

Given these uncertainties, **we recommend that only investors with above average risk appetite should consider holding the ABN Amro 5.9% Callable Non-cumulative Perpetual Trust Preferred Securities. Risk averse investors should sell.**

Allianz 8.375% Undated Subordinated Callable Bonds (A+/Stable)

Coupon payments on the Allianz 8.375% Undated Subordinated Callable Bonds may be deferred at the discretion of the issuer. The issuer is required to defer coupon payments if on a coupon payment date the Allianz Group has insufficient funds to cover the required minimum solvency margin in accordance with the provisions of the German insurance regulatory law. Deferred coupon payments must be made on the fifth anniversary following the relevant payment date from which interest was originally deferred. Allianz may make any coupon payment through an Alternative Payment Mechanism but only if the company has raised the funds required by issuing shares within six months prior to the relevant payment date. In addition, Allianz may make any deferred payments through the issuance of Payment In Kind (PIK) in the shape of additional undated subordinated bonds. Allianz has the right to substitute at any time without the approval of the bondholders the subordinated bonds by Qualifying Solvency Securities which qualify towards regulatory solvency capital under German law. Such new securities would rank senior to, or *pari passu* with, the Undated Subordinated Bonds. Also, the new securities would preserve any existing rights to any deferred interest payment.

On January 12, Allianz completed the sale of Dresdner Bank to Commerzbank, and now has a 14% stake in Commerzbank. Total revenues decreased slightly in Q3 2008 by 3.8% to EUR21.1bn, compared to EUR21.9bn the year before. Operating profit decreased more than forecast to EUR1.6bn, compared to EUR2.6bn in the same period of 2007. However, for the first three quarters of 2008, the company reported a very respectable operating profit of EUR6.5bn. Nevertheless, Allianz said it may miss its operating profit target of at least EUR9bn in 2008 and 2009. Allianz is scheduled to report Q4 2008 results on February 26.

Despite volatility in the financial markets, Allianz has maintained its relatively strong capital and solvency positions. With shareholders' equity of EUR37.5bn as of end Q3 2008, Allianz Group's capital base remained at a high level. As of September 30 2008, Allianz's available funds for the solvency margin were EUR43.5bn (slightly down from EUR46.5bn as of end-2007), surpassing the minimum legally stipulated level by EUR15.8bn (down from EUR17.6bn end-2007). This margin resulted in a solvency ratio of 157% which was slightly down from 161% as of end 2007, but above Allianz's internal target of 150%.

S&P reaffirmed its AA rating with a stable outlook on 18 December 2008. The rating reflects the insurer's solid capital adequacy, strong underlying performance and solid competitive position. The stable outlook mirrors the expectation that although there is a likelihood of further material write-downs, Allianz's very strong capitalization will continue to be supported by the company's strong risk management and solid internal capital generation.

At the current price of 17.5, the Allianz 8.375% Undated Subordinated Callable bonds are yielding 11.9%. **Given the group's relatively strong capitalization and the low likelihood of coupon deferral, we recommend investors to keep on holding the Undated Subordinated Bonds.**

ING 7.375% Callable Perpetual Hybrid Capital Securities (A/Negative)

The ING 7.375% Callable Perpetual Hybrid Capital Securities are subordinated and coupon payments can be deferred at the discretion of the issuer. Unless a required deferral occurs, deferred coupon payments may be paid on any pre-specified business day after the occurrence of the deferral. However, deferred coupon payments can only be paid by proceeds from the issuance of securities that rank pari passu with or junior to the Capital Securities (and are eligible as tier 1 capital). A required deferral could occur as a result of ING not being solvent and/or if the Dutch Central Bank has requests that payment not be made.

In January, ING Group reported a preliminary net loss of EUR1bn for 2008 driven by a very weak H2 2008. Results were impacted by impairments and losses on pressurized assets (including subprime RMBS, Alt-A RMBS and CDOs/CLOs) of EUR2.0bn, on equity securities of EUR0.7bn and on debt securities of EUR0.3bn. ING announced it aims to cut EUR1bn of costs in 2009, equivalent to about 6.5% of the cost base. The insurer will book a net restructuring charge of EUR450mn in H1 2009. ING's capital and capital ratios remain strong. Total equity was EUR28.6bn at year end 2008, up from EUR25.6bn at the end of Q3 2008, including EUR10bn core tier-1 securities issued to the Dutch State. ING Bank's tier-1 ratio was 9.1% at year-end with a core tier-1 ratio of 7.1%.

Meanwhile, ING and the Dutch government have reached an agreement on an Illiquid Assets Back-up Facility covering 80% of ING's EUR27.7bn portfolio of Alt-A mortgage securities. ING will pay to the Dutch state an annual guarantee fee consisting of a fixed amount plus a percentage of the payments received on the securities. The risk transfer is expected to increase ING's tier 1 capital ratio by 40bp to 9.5%.

S&P reaffirmed its AA- rating on ING Group on 27 January. The outlook remains negative on concerns that earnings will remain under pressure.

The ING 7.375% Callable Perpetual Hybrid Capital Securities trade at a price of 12, yielding 15.4%. The recent coupon payment on January 15 indicates both the current willingness and ability of ING Group to continue coupon payments on the Capital Securities. Meanwhile, the insurer's solvency – as measured by the latest tier 1 capital ratios – is adequate.

As coupon deferral still seems unlikely in the short-term, and although downgrade risk and extension risk may continue to weigh on the hybrid capital securities for some time, these risks seem to be reflected in current prices. Therefore, **investors should keep on holding the ING 7.375% Callable Perpetual Hybrid Capital Securities. Risk averse investors should consider reducing exposure at times when spreads recover.**

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Important Information