



Wilary Winn Risk Management LLC

Recent Trends in the Performance of Pooled Trust Preferred Collateralized Debt Obligations

Wilary Winn Risk Management, LLC (“WW Risk Management”) is one of the leading providers of valuations of pooled trust preferred collateralized debt obligations (TRUP CDOs) in the country. As of August 2011, WW Risk Management analyzes 60 TRUP CDOs containing \$32.3 billion of collateral. This represents 53 percent of the 113 total TRUP CDO deals issued globally and 51 percent of the \$63 billion original collateral balance supporting the CDOs. This white paper summarizes the recent trends we have observed regarding the performance of these securities. As background, Appendix A provides a general description of TRUP CDOs.

Collateral Input Assumptions That Determine TRUP CDO Value

The performance of the CDO is dependent on the performance of the trust preferred securities underlying the deal. The key inputs used to estimate the performance of the trust preferred securities supporting the CDO are:

- The rate of expected defaults – conditional default rate (“CDR”)
- The loss arising from a default – loss severity
- The rate of expected prepayment – conditional repayment rate (“CRR”)

TRUP CDO cash flows and default assumptions are influenced by deferrals. An issuer of a trust preferred security generally has the right to defer interest payments for up to five years. Until recently, most of the institutions that deferred ultimately defaulted. For this reason, much of the concern with regard to the TRUP CDOs focused on the institutions that had deferred and many equated a deferral with a default.

WW Risk Management began performing TRUP CDO valuations in late 2008. Based on the data we have collected as part of our valuation process for the deals we value, we have noted the following from that time through August, 2011.

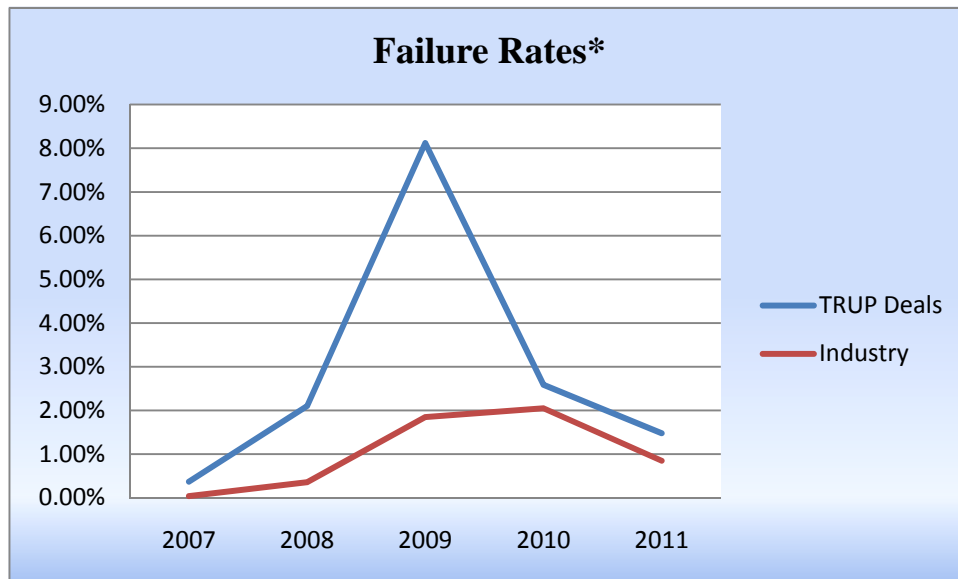
1. Defaults on trust preferred securities have been the key recent driver of TRUP CDO performance. The default rates peaked in 2009, and have since declined.
2. After seeing very few deferrals cure historically, we have seen 18 issuers cure thus far in 2011 across all the deals we value. In addition, we note 19 deferring issuers that have recently been recapitalized or sold, and we believe the cures for these securities are forthcoming.

3. In the majority of the deals we value, the issuers we believe will not default are on average financially stronger than the aggregate average of all FDIC-insured institutions. This creates a "survivor bias" and we believe future default rates for these trust preferred securities will likely be consistent with the long-term default rate for the industry versus the relatively higher default rates we observed in recent years for issuers of trust preferred securities.
4. After seeing very few prepayments from 2008 to 2010, we are beginning to see prepayments of the underlying trust preferred securities – particularly by the big banks.

Will a Bank Deferral Always End Up as A Default for the TRUP CDO?

Recent Rates of Default

As shown in the chart below, during the early stages of the financial crisis, the failure rates for the issuers of the trust preferred securities underlying the TRUP CDOs we value were markedly higher than failure rates for the industry as a whole.



*2011 failure rate is through August 12

Prior to late 2010, very few issuers that deferred were able to cure their deferral and subsequently defaulted. Beginning in 2010, this difference in failure rates began to narrow significantly and we are now seeing many deferring issuers cure the deferral.

We believe the decrease in the default rate on trust preferred securities is due to the length of the boom, bust, and recovery cycle and that we are too early in the cycle to arbitrarily conclude that a deferral is a default. Most of the trust preferred securities were issued since 2000 as the banking industry was booming, and are therefore relatively new. Following this boom, we saw a

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crisis and a wave of early defaults. We have then seen, and are now still seeing, recapitalizations and an increase in M & A activity. For example, as shown in the attached Appendix B, 18 issuers cured their deferring trust preferred securities so far in 2011 across the deals we value.

WW Risk Management believes the ability to generate capital is predictive of a troubled bank's ability to recover. A study by the FDIC on the rate of failure by troubled banks from 1990 to 2002 showed that 72% of the banks that increased risk based capital recovered.¹ The capital can come from the outside or can be raised internally through better performance or the sale of assets. Appendix C shows 19 deferring issuers that have recapitalized or become acquired since the start of 2010 among the deals we value. We expect the cures on these issuers' deferrals will be forthcoming.

Forecasted Rates of Near-Term Default

WW Risk Management believes we will continue to see a downward trend in bank failures and defaults and we note that other industry experts also believe the banking environment is improving. According to SNL Financial on March 30, 2011, FDIC Senior Policy Analyst George Parkerson stated at the IMN Bank and Special Asset Executive Forum that "...banks with the greatest amount of problems have already failed and that since then, new capital has flowed into the banking industry, helping institutions address their credit quality issues. He said bank failures have slowed as the economy has stabilized and banks have worked through their distressed assets. He said that the most severe issues facing banks appear to be calming and noted that the FDIC believes bank failures peaked in 2010". SNL Financial also notes that fewer TRUPs issuers are deferring interest payments, as credit quality improves and confidence in issuers' debt servicing ability rebounds.²

In a recent research report, Moody's outlined its view that ratings of TRUP CDOs will generally be stable for the second half of 2011.³ Moody's points to the declining pace of bank failures, with the failure rate peaking in 2009 and 2010, as one reason to expect the TRUP CDO sector to stabilize. Another indicator of stabilization is the leveling off in the number of banks added to the FDIC's "problem banks list." Additions to this list peaked in 2009, when 450 new banks received the label. The list grew by 182 banks in 2010, while the first quarter of 2011 saw only four banks added to the list. Furthermore, the number of problem banks declined by 23 in the second quarter of 2011, the first such decline since the third quarter of 2006. Consistent with our own research, Moody's adds in their aforementioned recent report that some banks previously in deferral have now become current on their interest payments, either through improved financial performance, capital injections, or M & A transactions where a healthy bank takes control of a weakened bank.

¹ FDIC Banking Review – Troubled Bank: Why Don't They All Fail? – Robert Oshinsky and Virginia Olin – 2006 Volume 18, No. 1

² SNL Financial – With Credit Quality on the Mend, TruPS Deferrals Petering Out – Lindsey White and Rebecca Wren – August 11, 2011

³ Moody's Structured Credit Perspectives – TRUP CDO Sector Shows Encouraging Signs of Stabilization – Rachid Ouzidane, Sange Lama, Rodrigo Araya, and Jian Hu – July 6, 2011

Recent Events

WW Risk Management also recognizes the recent market turmoil of August 2011 has the potential to again freeze credit markets, as the euro-zone debt crisis could infect the global banking system. However, bank funding markets in the U.S. are showing little sign of stress and appear to be quite stable, nowhere near the panic-driven levels of late 2008. With the Federal Reserve now on hold until at least mid-2013, financial institutions' access to credit should remain relatively cheap and abundant, barring any major shocks. We also note that if recent fears of a double-dip recession in the U.S. come to fruition, the result may be deterioration in the asset quality of TRUPs issuers, possibly inducing a greater number of deferrals and defaults.

Forecasted Long-term Default Rates for Issuers of Trust Preferred Securities

WW Risk Management's analysis of the TRUP CDO pools we value leads us to believe that the issuers within the pools which we believe will not default are on average financially stronger than the average of all FDIC-insured institutions. As the two shaded columns in the following table indicate, the key ratios of the active issuers for which we currently do not have a default assumption are relatively stronger than the aggregate for all FDIC-insured institutions. The banks have higher Tier 1 capital, fewer non-current loans, and higher loan loss reserves. On the other hand, they have a slightly higher Texas Ratio than the aggregate.

3/31/2011 Call Report Data	All Deals Valued by WWRM				
Ratios	All active Bank issuers	All active Bank issuers excluding issuers assumed to default	All active Bank issuers deferring with no default assumption	All active Bank issuers with a default assumption	FDIC SDI Data - All Institutions
Tier 1 Capital Ratio	12.79%	13.44%	13.44%	8.81%	13.04%
Non-Current Loan to Total Loans	4.37%	3.66%	5.83%	9.01%	4.71%
Loan Loss Reserve to Non-Current Loans	105.38%	115.07%	62.97%	44.32%	63.85%
Texas Ratio	47.39%	36.78%	60.93%	124.71%	35.95%
Net Interest Margin (YTD)	3.68%	3.76%	3.63%	3.16%	3.66%
Efficiency Ratio (YTD)	70.77%	65.65%	80.05%	103.63%	60.75%
ROAA (YTD)	0.51%	0.72%	0.17%	-0.82%	0.87%
Total Loans/ Deposits	80.33%	80.52%	77.81%	79.03%	75.49%
Number of Issuers	1059	909	155	150	7,574

WW Risk Management believes that the relative strength of the remaining issuers in the deals, excluding those assumed to default, creates a "survivor bias" and we believe future default rates for these trust preferred securities will likely be consistent with the long-term default rate for the industry versus the default rates we observed in recent years for issuers of trust preferred securities. As a result, WW Risk Management believes that there is no need to vector terminal CDRs upwards solely on the basis of high historical TRUP failure rates⁴.

⁴ We note that in order to construct the table we summarized the active issuers by creating a weighted average based on issue size, then divided the issuers into categories based upon their status of deferral and whether or not WW Risk Management assigned a default assumption to the issuer. To ensure an accurate comparison, WW Risk

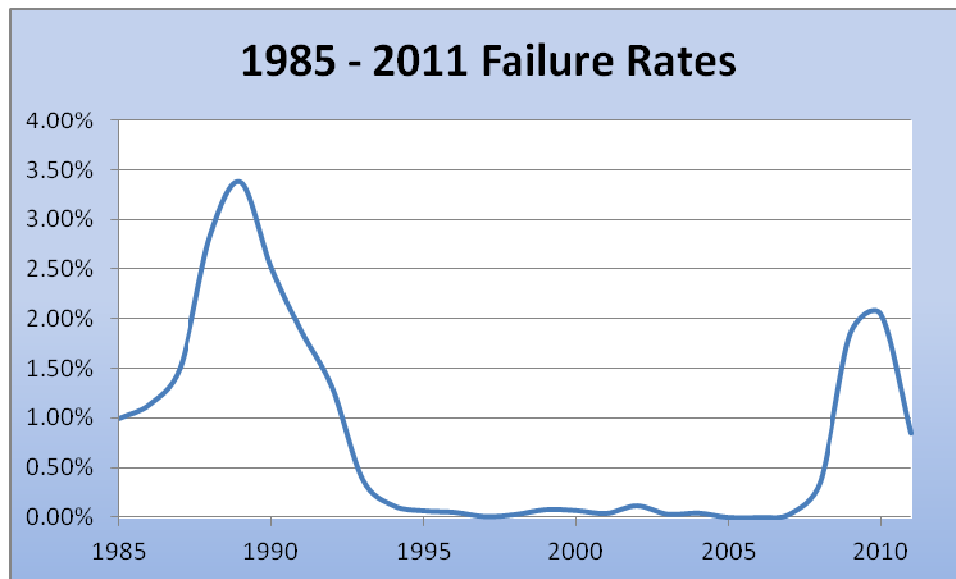
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In our experience, most experts are basing their estimates for longer-term rates of deferral and defaults on historical averages. For example, FTN Financial has estimated that the annual average default rate (defined as bank failure) from 1934 to 2008 was 36 basis points.

As another example, in 2002, Salomon Smith Barney issued a research report entitled Historical Default Rates of FDIC-Insured Commercial Banks, 1934-2001 (the Salomon paper). The Salomon paper defines a default as any instance when a regulator takes an active role in a bank's operations under a supervisory action. This definition of default is distinct from failure. The Salomon paper considers a bank to have defaulted if it falls below minimum capital requirements or becomes subject to regulatory actions including a written agreement, or a cease and desist order. The Salomon paper calculates the default rate as a fraction in which the numerator represents the number of issuers that default and the denominator represents the number of banks at risk of defaulting. The highest single year default rate in the Salomon paper is 1.58%, which occurred in 1988. WW Risk Management notes that since the paper was published we have seen two instances which the actual failure rate exceeded the 1.58% – there were 148 failures in 2009 (a rate of 1.85%) and 157 in 2010 (a rate of 2.05%).

Because of the recent spikes in failure rate, some experts believe that a long term failure rate should be based on the most recent 25 years, which approximates 81 basis points versus the 36 basis points calculated in the longer duration FTN study. WW Risk Management notes that the 81 basis point failure rate includes two extremely challenging time periods for the banking industry, which may not be indicative of future long-term trends. As the table below shows, the 25 year failure rate resembles a barbell curve, with failures heavily concentrated in the late 1980s during the savings and loan crisis and in the most recent financial crisis of 2008.



Management calculated the standard deviation across the issuers for each ratio and removed any issuer that fell more than three standard deviations above or below the average for that ratio.

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Because of the barbell distribution, we base our long-term default rate on the 0.36% provided in the FTN study.

Loss Severity

The fact that a trust preferred issuer defaults does not necessarily mean that an investor will lose all of their investment. Thus, it is important to understand not only the default assumption, but also the expected loss given a default, or the loss severity assumption.

On November 21, 2008, Standard & Poor's (S&P) published, *Global Methodology for Rating Trust Preferred/Hybrid Securities Revised*. In that study, S&P indicated that their assumption for recoveries on hybrid securities issued by banks is 15% equating to a loss severity assumption of 85%.

Moody's Analytics has performed research that confirms that recoveries on defaulted trust preferred securities are low (i.e. less than 20%). Research by Moody's Analytics shows loss severity based on the type of impairment:

Impairment type	Loss Severity
Dividend omission	92%
Chapter 11	97%
Missed payment	92%
Other	98%

For securities that have already defaulted, WW Risk Management assumes a loss severity of 100%. For deferring securities, we assign a probability of default and assume a loss severity of 100%. We also recognize TRUPs holders of certain defaulted issuers will recover some portion of their investment, as some issuers currently in bankruptcy proceedings are expected to have sufficient assets remaining to repay at least a portion of their TRUPs. For example, even though Colonial BancGroup, Inc. and Corus Bankshares, Inc. have both defaulted on their TRUPs, we expect the loss severities on those issues to be less than 100%.

Prepayments

Trust preferred securities generally allow for prepayment without a prepayment penalty any time after five years. Prepayments affect the securities in three ways. First, prepayments lower the absolute amount of excess spread, an important credit enhancement. Second, the prepayments are directed to the senior tranches, the effect of which is to increase the overcollateralization of the mezzanine layer. However, the prepayments can lead to adverse selection in which the strongest institutions have prepaid, leaving the weaker institutions in the pool, thus mitigating the effect of the increased overcollateralization. Third, prepayments can limit the numeric and geographic diversity of the pool, leading to concentration risks.

Prior to August 2007, the spread to the benchmark on trust preferred securities narrowed. Because of the narrowing of spreads, many financial institutions prepaid their outstanding trust preferred securities at the five year mark (when the lockout expired) and refinanced. However,

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as a result of the financial crisis in 2008, prepayment of trust preferred securities virtually ceased until this year. WW Risk Management believes the increase in prepayment activity is due in part to the recently enacted Dodd-Frank Act. Under the Act, depository institution holding companies with more than \$15 billion of total assets at December 31, 2009, will no longer be able to count trust preferred securities as Tier 1 regulatory capital beginning January 1, 2013. Similarly, U.S. bank holding company subsidiaries of foreign banking organizations with more than \$15 billion in total assets will no longer be able to count trust preferred securities as Tier 1 capital beginning July 1, 2015.

Since the beginning of 2011, we have seen 21 unique issuers fully redeem their TRUPs across the range of deals we value as shown in Appendix D. The redemptions consist mostly of larger banks that have prepaid either because they can find less expensive funding elsewhere or because of the restrictions imposed by the Dodd-Frank Act. We have also seen a number of partial prepayments recently as well, mainly among the insurance company issuers and the smaller banking institutions. WW Risk Management believes that over the near term, the highest rates of prepayment will be in fixed rate issuances of large banking holding companies.

Authored by:

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About the Authors

Gregg Johnson

Wilary Winn Risk Management Vice President of Operations Gregg Johnson has over fifteen years of experience in the financial services and retail industries. Mr. Johnson's areas of expertise include quantitative analysis, integrated software technologies, client/project management, and marketing.

Prior to joining Wilary Winn Risk Management, Mr. Johnson served as Manager of Client Relations and Project Management for an interactive marketing company working with financial services clients such as Ameriprise Financial, Oppenheimer, and RBC Wealth Management. Mr. Johnson also has twelve years of experience working with major retailers on quantitative analysis and software integration, including:

- Developing inventory flow models based on seasonal and geographic trends as well as capacity constraints
- Financial modeling and budgeting, including loss reserve forecasting
- Integration, testing, and implementation of complex merchandising systems

In addition to this experience, Mr. Johnson has also successfully launched an online sales and marketing corporation which he currently serves as an active board member.

Gordon Bowers

Gordon Bowers is a Financial Analyst with Wilary Winn Risk Management. Mr. Bowers graduated from the University of St. Thomas with bachelor's degrees in finance and economics. He has passed all three levels of the CFA Program and will be eligible for the CFA charter upon completion of the required work experience. Gordy teams with senior Wilary Winn Risk Management consultants on a variety of engagements, including valuation of pooled trust preferred collateralized debt obligations, non-agency mortgage-backed securities, and determination of fair value.



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Appendix A

Trup CDO General Characteristics

A TRUP CDO is an asset-backed security backed by capital securities and senior and subordinated securities issued by depository institutions or their holding companies, as well as capital securities and senior debt issued by insurance companies or their holding companies. These securities are often referred to as trust preferred securities. The purchase of the trust preferred securities is made using the proceeds of debt and equity issued by the special purpose entity. The debt is in the form of bonds, which are segregated into classes or tranches. The bonds issued generally include senior, mezzanine and an income or equity tranche. The senior bonds receive a payment priority and losses are allocated to the junior bonds according to their hierarchy beginning with the income or equity tranche. In addition, certain tests must be satisfied before cash flow from the CDO collateral can be distributed to the mezzanine and equity tranches.

Trust preferred securities are often thought of as hybrid securities because they have features of both debt and equity. Trust preferred securities generally have a very long term (usually 30 years), are interest only, are unsecured, are subordinate to all other debt issued, or to be issued, by the issuer. In addition, trust preferred securities include a provision that allows the issuer to defer interest payments for up to five years. On the other hand, the holders of trust preferred securities benefit from traditional remedies accorded to a lender including the right to accelerate in the event of a default. The primary issuers of trust preferred securities were bank holding companies, which generally down-streamed the proceeds to their bank subsidiaries, generating favorable tax and regulatory capital treatment.



Appendix B - 2011 Cures Through August 17

Bank Name	Issue Amount	Deals	Cure Date
Brookline Bancorp, Inc (First Ipswich Bancorp)	6,000,000	PreTSL VII	4/1/2011
	7,000,000	Soloso	4/1/2011
Citizens National Corporation	6,000,000	PreTSL XXII	3/1/2011
	10,000,000	PreTSL XXVI	3/1/2011
First Bancorp	10,000,000	RegDiv 2004	4/1/2011
First Independence Corporation	3,000,000	PreTSL VI	4/1/2011
	3,000,000	PreTSL XXIII	3/1/2011
Heartland Bancshares, Inc.	3,000,000	PreTSL XXIV	3/1/2011
Heritage Commerce Corp	4,000,000	PreTSL VII	7/1/2011
H.O.M.E. Incorporated	3,000,000	Alesco 5	3/1/2011
IBERIABANK Corp	7,500,000	PreTSL XIII	6/1/2011
Inland Bancorp	5,000,000	Alesco 3	4/1/2011
	10,000,000	Alesco 8	4/1/2011
Jacksonville Bancorp (Atlantic BancGroup)	3,000,000	PreTSL XIX	3/1/2011
Kirkwood Bancorporation Co.	5,000,000	Alesco 4	4/25/2011
Pacific International Bancorp, Inc.	4,000,000	PreTSL XIX	3/1/2011
Primesouth Bancshares, Inc.	4,000,000	PreTSL XVIII	3/1/2011
TD Bank (South Financial Group, Inc., Carolina First Bank)	13,200,000	PreTSL II	3/1/2011
	3,000,000	PreTSL X	1/1/2011
	7,500,000	PreTSL XXVIII	12/1/2010
	30,000,000	TRAP 13	3/1/2011
Tower Bancorp, Inc (First Chester County)	10,000,000	RegDiv 2004	4/1/2011
Trinity Capital Corporation	1,000,000	Alesco 9	4/1/2011
	10,000,000	RegDiv Fund	4/1/2011
	10,000,000	PreTSL XXIV	6/1/2011
Voyager Financial Service Corp.	3,000,000	MM Co. Fund 3	3/1/2011
West Coast Bancorp	6,000,000	PreTSL XIII	6/1/2011
	15,000,000	PreTSL XXII	6/1/2011
	5,000,000	PreTSL XXV	6/1/2011
	17,500,000	PreTSL XXVI	6/1/2011



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Appendix C - Recapitalized & Recently Acquired Banks

Financial Institution	Capital Raised	Closed / Pending
Saehan Bancorp	60,573,000	Q1 2010
North Valley Bancorp	40,000,000	Q2 2010
Seacoast Banking Corporation of Florida	50,000,000	Q2 2010
Hanmi Financial Corporation	120,000,000	Q3 2010
Mission Oaks Bancorp	7,000,000	Q3 2010
Pacific Capital Bancorp	576,437,000	Q3 2010
Sterling Financial Corporation	730,000,000	Q3 2010
TIB Financial Corp.	175,000,000	Q3 2010
Hampton Roads Bankshares, Inc.	295,000,000	Q3 & Q4 2010
Patriot National Bancorp Inc.	50,400,000	Q4 2010
Cadence Financial Corp.	Acquired	Q1 2011
Central Pacific Financial Corporation	325,000,000	Q1 2011
United Community Banks, Inc.	380,000,000	Q1 2011
Cascade Financial Corporation	Being Acquired	Pending
Community Capital Corporation	Being Acquired	Pending
Crescent Financial Corporation	75,000,000	Pending
Green Bankshares, Inc.	217,000,000	Pending
Intermountain Community Bancorp	70,000,000	Pending
Prosperity Banking Company	81,000,000	Pending



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Appendix D - 2011 Redemptions Through August 17

Issuer	Total Assets (in millions USD)	Total Amount of Issuance Redeemed
BMO Financial Group	482,228	10,000,000
Brookline Bancorp	3,115	13,000,000
Capitol Federal Financial, Inc.	9,602	39,500,000
Chinatrust Capital Corporation	1,604	17,005,000
Danvers Bancorp, Inc.	2,774	10,000,000
Fifth Third Bancorp	110,805	10,000,000
FirstComp Insurance Company	308	15,000,000
IBERIABANK Corporation	11,452	13,500,000
Kearny, MHC	2,904	5,000,000
Marshall & Ilsley Corporation	49,641	75,000,000
Mitsubishi UFJ Financial Group, Inc.	2,701,174	13,000,000
MortgageIT Holdings, Inc.	8,470	50,000,000
Pine City Bancorporation	N/A	2,000,000
Prosperity Bancshares, Inc.	9,657	7,000,000
State Capital Corporation	917	3,000,000
Toronto-Dominion Bank	637,362	73,500,000
U.S. Bancorp	320,874	7,500,000
Webster Financial Corporation	17,807	10,000,000
Wells Fargo & Company	1,259,734	33,550,000
WesBanco, Inc.	5,426	23,750,000
Xerox Corp	31,095	10,000,000