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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Consolidation in Banking

The banking industry continues to consolidate throughout the United States, but at a much slower pace than in the past two decades. Consolidation occurs from a number of factors with banks experiencing loan and securities portfolio problems resulting in inadequate capital on one hand and the pricing of banks in acquisition transactions on the other hand. The Federal Deposit Insurance Corporation ("FDIC") reports that the number of insured institutions has declined over 40% since 1992.

Depressed stock prices for publically traded financial institutions is a factor in the decline in merger and acquisition activity because there is less buying power by an acquirer with the result that a healthy institution is unwilling to accept a lower price. Probably the most significant factor in the decline is the closure of banks by the FDIC resulting in acquirers for banks purchasing the assets of the closed bank at a modest premium of the deposits, and the FDIC entering into a loss-sharing agreement with the acquirer on potential loan and asset losses. Because of FDIC closure of banks and the utilization of loss-sharing agreements, acquirers have in some cases either excluded or escrowed problem assets in making an acquisition of a healthy bank thereby leaving the risk of collection of the problem assets with the shareholders of the acquired institution.

Since 2007, merger and acquisition activity has continued to decline. Although there are still acquirers for banks, they are much more selective in the acquisitions that are being made. The number of institutions on FDIC's *problem list* has risen to 552, the highest level in 16 years. Problem institutions are characterized as those institutions having a risk of failing and being closed by the FDIC.

Prior to 2007 there had not been a bank failure since the second quarter of 2004. During 2007 there were three bank failures with the largest being NetBank located in Georgia. During 2008 there were twenty-six bank failures with the largest being Washington Mutual Bank in Washington. During 2009 there were 140 bank failures with the largest being Colonial Bank located in Alabama. So long as closures by the FDIC continue at the current pace, the merger and acquisition activity will be depressed.

Probably the biggest issue facing banks during the coming year will be the ability to raise capital, not only for acquisitions but for credit quality issues relating to loan portfolios and securities portfolios. Banks will need to look for alternatives for capital, one of which would be the private placement of its equity, debt or hybrid (trust preferred and noncumulative perpetual preferred) securities with local investors, existing shareholders and major customers.

Our firm is available to answer questions regarding the benefits of issuing securities in a private placement.

Preferred Stock

In recent years bank holding companies and other financial institutions have become the largest issuers of preferred stock. The issuance of traditional preferred stock by a bank holding company will normally qualify as tier 1 capital. There are basically four types of preferred stock: (i) cumulative preferred, (ii) noncumulative preferred, (iii) participating preferred and (iv) convertible preferred. Preferred stock will generally pay dividends either as a percent of par value or a specific dollar amount and are paid quarterly. In most cases preferred stock does not have voting rights and dividends will be cumulative.

Preferred stock is senior to common stock but is junior to creditors and bondholders. It is not unusual for preferred stock to have a call provision that allows the issuer to call the shares at any time or after five years. The dividends on traditional preferred stock are taxed at the qualified dividend income rate of 15%. The dividends on traditional preferred stock to any incorporated investor are 70% tax-exempt. Therefore, a corporation with a 35% tax rate pays only $10.50 on every $100 in dividends versus $34.00 in tax on every $100 from interest payments.

Another form of preferred stock is known as convertible preferred. Convertible preferred allows the holder to convert the shares into the issuer's common stock at a preset conversion price. Since convertible preferred stock allows for the opportunity for capital appreciation through the conversion into the issuer's common stock, the dividend will generally be lower than the dividend on non-convertible preferred stock.

Participating preferred stock allows the holder to receive earnings over and above a specified dividend amount. Participating preferred stock is sometimes utilized as a poison pill in the event of an unwanted takeover by allowing the existing holders to buy more shares at a substantially reduced price.

Preferred stock may also be cumulative or noncumulative. Cumulative preferred stock allows the holder to obtain dividend payments which were not paid in a timely manner by the issuer. If the issuer misses one or more dividend payments, then the holder has the right to receive these missed payments before any dividends can be paid to the holders of the issuer's common stock. However a holder of noncumulative shares does not have this right.

In recent years, trust preferred stock has been the more prevalent form of preferred securities issued by bank holding companies. Under regulations adopted by the Federal Reserve Board, bank holding companies may include trust preferred securities in tier 1 capital in an amount equal to 25% of all core capital elements (including trust preferred securities). Amounts of restricted core capital elements in excess of this limit generally will be included in tier 2 capital. Although a Subchapter S corporation cannot have more than one class of stock, trust preferred securities are not considered a separate class of stock and purchasers of trust preferred securities are not counted as additional shareholders. A significant advantage to the issuance of trust preferred stock over traditional preferred stock is that the dividends are deductible to the issuer while dividends paid on traditional preferred stock are not. Trust preferred stock is senior to traditional preferred stock, but it is junior to other senior debt.

Our firm is available to answer questions on the benefits of issuing preferred stock and the placement of it with local investors and third parties.

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