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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 acquiror on potential loan and asset losses.

A good example of an acquirer making an acquisition from the FDIC is the closure on August 7, 2009, of Community National Bank of Sarasota County, Florida where the FDIC accepted a premium of 0.25 percent for the assumption of all of the deposits and entered into a loss-share agreement with the acquirer to share in 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.

The average price on the 272 bank and thrift transactions announced in 2007 had a price/book multiple of 2.20 and a price/earnings ration of 22.65. During 2006, there were 275 bank and thrift transactions announced at an average price/book multiple of 2.36 and a price/earnings ratio of 27.87. During 2005, there were 253 bank and thrift acquisitions announced at an average price/multiple of 2.28 and an average price/earnings ratio of 26.16.

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.

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 with approximately $2.5 billion in assets and $2.3 billion in total deposits.

During 2008 there were twenty-six bank failures with the largest being Washington Mutual Bank located in Washington with approximately $307 billion in assets and $188 billion in deposits. During the first eight months of this year, there were eighty-four bank failures with the largest being Colonial Bank located in Alabama with approximately $25 billion in assets and $20 billion in deposits. For the first six months of this year, there were only seventy-seven transactions announced, some of which have already been terminated. 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. Because of the increasing number of banking institutions electing to defer interest payments on trust preferred securities, those banks having ownership in pools of trust preferred securities commonly referred to as "collateralized debt obligations" are beginning to experience securities portfolio problems.

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.

Collateralized Debt Obligations

Collateralized debt obligations ("CDOs") are generally defined as investment grade securities that are backed by a pool of loans, trust preferred securities issued by bank holding companies, subordinated notes issued by banks, other assets and similar instruments issued by insurance companies. CDOs are complex in that they represent different types of debt and credit risks.

The different types of debt in a CDO are referred to as *tranches* or *slices*. The "tranche" comes from the French word for "slice". A standard feature of CDOs is credit tranching. This credit tranching refers to creating multiple classes, i.e., tranches of securities, each of which has a different seniority relative to the others. The higher class will be referred to as "senior debt", whereas a lower class will be referred to as "subordinated debt" since this debt is subordinated to the senior debt. Even though these slices contain the same underlying debt, they differ in terms of preference, interest payments and risks. The higher the risk, the more the CDO will pay. Tranches that pay the least interest are the safest and will generally have a rating of "AAA" since they will be the first to be paid, whereas lower and riskier tranches will either have lower investment grade ratings or be non-rated.

CDOs are most often purchased by entities generally referred to as *qualified institutional buyers*, such as insurance companies, employee benefit plans, investment companies and banks.

The packaging of debt in the form of CDOs pretty much dried up in the Fall of 2007 with the downturn in the subprime mortgage market. Because CDOs are thinly traded and have little liquidity, there is insufficient market data to determine the value of such holdings based on recent sale prices. Instead, models are used to demonstrate prices when reporting them to investors who depend heavily on the credit ratings issued by Moody's, Fitch and Standard & Poors. In recent months civil lawsuits have been brought relating to the valuation, marketability and suitability of CDOs.

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