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Prospecting Among Acquirers of Failed Banks

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Since the financial meltdown began, over 160 banks have failed and been taken over by the Federal Deposit Insurance Corporation (FDIC). As the banking industry continues working through $ billions of troubled residential and commercial real estate loans, more bank failures are inevitable. However, while banks of varying sizes have suffered substantial setbacks during this financial meltdown, the healthy banks stand to gain from acquiring failed banks, with the FDIC's financial assistance.

After taking over a failed bank, the FDIC aims to find a buyer to take on the failed bank's loans, deposits, branches and other assets to minimize loss to the government and taxpayers. As the number of bank failures increases, the FDIC is eager to unload the rapidly accumulating (but deteriorating) assets and find buyers to protect depositors by assuming the deposits. To encourage and speed up this process, the FDIC is often forging loss-sharing agreements with the acquiring banks.

Under the typical loss-sharing agreement, the FDIC agrees to absorb a substantial portion of the future losses on the covered assets. Such agreements tend to run for 5 to 10 years, during which period most of the losses on acquired assets will have materialized. The FDIC typically agrees to assume 80% of losses on the covered assets up to its estimated threshold of the total projected losses and 95% of any losses above that. This effective and attractive risk-reducing feature provides the bidding banks a good idea of their maximum potential losses when they make their bids. To date, the FDIC has offered some spectacular deals -- there have even been cases in which the acquiring bank won the auction by bidding only a small premium for the deposits but a bigger *negative* bid for the assets, i.e. the acquiring bank got paid to take the failed bank off the FDIC's hands.

The favorable terms of the loss-sharing agreements give the healthy banks valuable opportunities to grow on the cheap at a time when many weaker institutions have been shrinking and de-

Thanks for your referrals!

As we conclude our fifteenth year of publishing *Observations*, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends, and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past fifteen years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

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leveraging. Potential benefits to healthy acquirers include picking up new deposit franchises with manageable and contained credit risk, increasing market share, entering new markets cheaply and increasing economies of scale.

You should be pleased if you own stock in a healthy bank that is acquiring failed banks from the FDIC. There is indeed strong interest among healthy banks to bid on the FDIC auction deals, accompanied by the FDIC's loss-sharing agreements. For example, U.S. Bancorp, the nation's sixth-largest bank with $264 billion in assets, has completed a number of FDIC-assisted transactions in the past year, allowing it to swiftly expand across the country. Just in October alone, U.S. Bancorp took over nine banking subsidiaries from the FDIC which belonged to FBOP Corporation that has $18 billion in assets and 150 branches in Texas, California, Illinois and Arizona. U.S. Bancorp's management has expressed interest in doing additional deals.

The big banks are not the only ones taking advantage of these opportunities to scoop up valuable assets, customer relationships and well-located branches at a discount, while being insulated from huge losses through agreements with the FDIC. Smaller banks have also participated. For example, in early November East West Bancorp doubled in size after acquiring San Francisco-based United Commercial Bank ("UCB"). The deal was accompanied by a loss-sharing agreement that covers substantially all of the loans acquired. The capped potential loss from the transaction is something that East West can easily and comfortably handle.

Of course even with the loss-sharing arrangements, FDIC-assisted deals are not risk-free. As with any merger, long-term benefits are unlikely unless the acquisition fits into the acquiring bank's strategic business vision. The acquiring bank also needs to have sufficient capital to take on impaired assets and maintain regulatory capital ratios, as well as the organization structure, resources and management capabilities to maximize the benefits from the acquisition.

In East West's case, the FDIC-assisted transaction makes tremendous financial and strategic sense. Thanks to the loss-sharing arrangement, credit exposure on the acquired assets is relatively minimal. With the $500 million of new equity capital raised prior to consummating the acquisition, East West's capital position is sufficiently strong to satisfy regulators, absorb losses from UCB assets and fund new loans at currently prevailing high rates (since financing is scarce, allowing lenders to charge high interest rates).

East West's acquisition of UCB is a textbook illustration of how such acquisitions should be done. Since UCB shares East West's focus in serving the Asian American communities, the acquisition fits into East West's business strategy. As a result of the acquisition, both the amount of deposits and the number of branches nearly doubled, expanding East West's presence both in the U.S. and China, and making it the largest bank in the nation focused on serving the Asian American markets. The acquisition of UCB will also provide positive operating leverage, improve operating margins, and accelerate East West's return to profitability.

With the FDIC's list of troubled banks increasing to 552 as of the end of the third quarter, the agency is far from done seeking buyers for failed banks; more FDIC-assisted deals are on the horizon. Healthy banks that have sufficient capital are poised to enjoy substantial benefits from taking over failed banks through loss-sharing agreements with the FDIC. This is particularly valuable at a time when many rivals are faltering in response to the financial meltdown and the recession. However, future deals will be less generous; FDIC has already signaled that it wants to start sharing in any increase in the acquirer's share price post-acquisition.

Taxable Custodial Accounts Versus Custodial 529 Plan Accounts

By Deborah W. Lee
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For many families, one of the most important financial priorities is saving for college educational expenses. In the past several years, tax-exempt 529 savings plan accounts have become increasingly popular as vehicles to build up college savings in a tax-advantaged manner. We have previously written about the pros and cons of these plans in Winter 2001 and Summer 2003 issues of ***Observations***. While somewhat dated, the main thrust of those articles still apply. In sum, we believe 529 plans are not nearly as attractive as their proponents have claimed.

Before 529 savings plans became popular, many families invested college savings in Education IRA's that provided some tax benefits. Because annual contributions to Education IRA's were limited, some families would also set up taxable custodial accounts to hold and invest assets gifted to children. A custodial account is an account set up and managed by an adult for the benefit of a minor until he or she reaches legal age, usually 18 or 21 depending on the state. The account is generally used to pass ***irrevocable*** gifts to a minor. Once the child reaches the legal age, he or she can take control of the entire account and use the funds *for any purpose*. While custodial accounts do not by their nature offer tax benefits, funding these accounts with gifts to children helps parents reduce their taxable estates and potentially subject a portion of the investment returns to the minor's lower tax rates.

Brokers get compensated very well for selling 529 plan accounts. What if your broker touts the considerable tax benefits offered by 529 plans, and advises you to "convert" from an existing taxable custodial account to a 529 plan account? You should be aware that this so-called "conversion" is highly complicated. Technically, it is not a conversion, but a two-step process that involves 1) selling all assets in the custodial account, producing normal tax consequences of net capital gains or losses; and 2) funding the 529 plan account with the assets (cash proceeds) of the custodial account, which legally belong to the child. The fact that the assets used to fund the 529 plan account in this situation belong to the minor makes the account different from a traditional 529 plan account. This is because a traditional 529 plan account is usually funded by an adult's assets. Unlike assets in a custodial account, which are ***irrevocable*** gifts that legally belong to the child, assets inside a traditional 529 plan account (less any taxes due) can revert back to the person setting up and funding the account if they are not used for qualified educational purposes. A 529 plan account funded with money from an existing custodial account is known as **a custodial 529 plan account**, distinct from a traditional 529 plan account.

Before deciding to transfer assets from a taxable custodial account to a custodial 529 plan account, you need to understand that you will not be getting exactly the same features offered by a traditional 529 plan account. The relative pros and cons of keeping money in a taxable custodial account versus transferring it to a custodial 529 plan account are presented in the table on the following page. You would be well advised to understand fully the contents of this table before deciding to "convert" a regular taxable custodial account into a custodial 529 plan account.

	Pros of "Converting"	Cons of "Converting"
Control of money	Encourages that the custodial money be spent on education, since money withdrawn for purposes other than to cover qualifying higher education expenses will be taxable and subject to a 10% penalty. However, this may actually pose a tax problem if you have earmarked part or all of the money that was in the custodial account for purposes other than college expenses.	Unlike traditional 529 plan arrangements under which beneficiaries can be freely changed, a custodial 529 plan account cannot change beneficiaries, because legally the child remains the owner of the assets at all times. The child can still withdraw the money from the 529 plan administrator for non-educational purposes when he/she reaches legal age (18 or 21), triggering taxes in the process.
Tax effect	Returns are not taxable until the money is withdrawn. If the money is withdrawn for qualifying higher education expenses, the returns are federally tax-free.	Since 529 plan accounts only take cash deposits, you have to liquidate all the investments in the custodial account prior to withdrawal to fund the new custodial 529 plan account. Possible tax consequences will at least partially negate the tax benefits of a custodial 529 account.
Investment options		You lose the investment flexibility and options available through a taxable custodial account. 529 plans have more limited investment choices and only allow you to change your selected investment options once a year. Investment results from most 529 plans will likely be mediocre, lagging the investment returns that are possible outside 529 plan accounts. In addition, there are added fees for 529 plan accounts.
Financial aid	Assets in a custodial 529 account *might possibly be* treated as the parent's assets *for financial aid calculation purposes*, which would enhance the student's eligibility for aid.	