



The Virginia State Banker

Regulatory news for Virginia State-chartered Banks

E.J. Face, Jr., Commissioner

Bureau of Financial Institutions - State Corporation Commission



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VIRGINIA BANK DIRECTORS' COLLEGE IN FOUR LOCATIONS THIS FALL

The Bureau of Financial Institutions (Bureau), the Federal Reserve Bank of Richmond, and the FDIC will present a “no frills--all substance” version of the Virginia Bank Directors’ College this fall. Our focus is to provide Bank Directors a one-day “emerging issues” program presented in four locations around the Commonwealth. Identical programs will be offered on the following schedule: October 23 at the Arlington-Sheraton National Hotel in Arlington, November 7 at the Martha Washington Inn in Abingdon, November 13 at the Farmington Country Club in Charlottesville, and November 15 at the

Williamsburg Marriott in Williamsburg. The program will be from 9 A.M. to 3 P.M., with lunch provided.

Representatives from the sponsoring agencies will discuss what directors need to know about real estate appraisals. FDIC representatives will present an overview of today’s economy and its effect on community banks. There also will be presentations on continuity planning and bank-related crime.

Program brochures and registration forms have been mailed to the banks. If you need additional information, please call Betty Nolan at the Bureau, (804) 371-9704.

The Virginia State Banker is published by the Virginia Bureau of Financial Institutions to provide useful information to the banks and savings institutions that it regulates, and any of their related interests. Reader comments and suggestions are welcome and should be addressed to Ginger Sandler, Bureau of Financial Institutions, P.O. Box 640, Richmond, Virginia 23218-0640, or via e-mail ginger.sandler@scc.virginia.gov.

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CONGRATULATIONS, DAN HEARN!

Principal Financial Analyst Dan Hearn has completed the Graduate School of Banking at the University of Colorado (GSBC). As reported in the Winter 2005 edition of *The Virginia State Banker*, Dan was awarded a scholarship from the Conference of State Bank Supervisors. He graduated in the top 10% of his class and was recognized as one of 14 honors students among 140 graduates of the 57th Annual

Session which was held on campus from July 15 through July 27, 2007. Dan received a graduate diploma in Banking.

GSBC is an intensive 36-month banking school for community banking professionals who are preparing for senior management/leadership positions. The program also includes on-campus courses, examinations, research projects, and a bank-management simulation course.

EARLY ADOPTION OF FAS 157 AND 159 FAIR VALUE ACCOUNTING

Nationwide, we understand that a number of institutions have “early” adopted Statement of Financial Accounting Standards No. 157 (FAS 157), *Fair Value Measurements* and FAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, after consultation with investment brokers and CPAs. A majority of these institutions have reclassified lower-yielding investments from a held-to-maturity (HTM) or available-for-sale (AFS) classification to the fair value option offered under FAS 159, which enabled unrealized gains or losses on these securities to bypass earnings and go straight to retained earnings on January 1, 2007. Subsequent to the reclassifications, many institutions sold their lower-yielding securities and replaced them with higher-yielding securities and classified them as HTM or AFS securities on a “go-forward” basis. Since many institutions appeared to be adopting FAS 157 and FAS 159 for the purpose of replacing lower-yielding investments with higher-yielding investments without classifying the replacements under the fair value option offered under FAS 159, questions were raised to the staff of the Securities and Exchange Commission concerning whether these investment strategies were consistent with the principles and objectives of FAS 159. As a result of these questions and the discussions that followed, on April 17, 2007, the Center for Audit Quality (CAQ), which is affiliated with the American Institute of Certified Public Accountants, issued an audit alert (CAQ Alert) to auditors concerning questionable practices

associated with the early adoption of FAS 159. The CAQ Alert may be accessed at the following web address:

http://www.aicpa.org/caq/download/CAQAlert2007_14_04172007.pdf.

The CAQ Alert discusses how an auditor should consider the investment strategies outlined above from an accounting standpoint and the conclusion an auditor should reach concerning their propriety under FAS 159. The CAQ Alert states the following concerning early adoption of FAS 159: “FAS 159 clearly articulates the principles and objectives of the standard. Principles-based standards should be applied in a good faith manner consistent with those objectives and principles. Although FAS 159 allows for early adoption . . . , auditors should exercise appropriate professional skepticism and be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard.”

“For example, assume an entity purports to adopt FAS 159 by electing the fair value option for certain eligible underwater AFS and HTM investment securities, and certain financial liabilities. Shortly thereafter, the entity disposes of those investment securities and settles those liabilities. The entity does not elect the fair value option for newly purchased investment securities and newly issued liability instruments. The totality of these actions appears to indicate that the entity has little or no intent to utilize the fair value option as a measurement attribute with respect to these classes of financial

assets and liabilities on a go-forward basis, contrary to the principles and objectives outlined in FAS 159. Accordingly, the entity’s purported adoption of FAS 159 is not substantive and would not be considered a proper application of FAS 159 . . .”

“If an entity proposes to adopt the fair value option merely to achieve an accounting result that is contrary to the principles and objectives in FAS 159 (i.e., recording unrealized losses directly in retained earnings coupled with little or no intent to apply the fair value option as a measurement attribute with respect to these classes of financial assets and liabilities on a go-forward basis), the auditor should reach a conclusion that the entity’s proposed accounting departs from generally accepted accounting principles.”

In view of the CAQ Alert, we would recommend that any institution that has early adopted FAS 159, under the circumstances shown above, consider meeting with their auditors to determine how an apparent departure from GAAP should be corrected, if in fact a departure is determined. Since Call Reports must be filed in accordance with GAAP, an institution may be required to adjust its books and records to comply with GAAP if an apparent departure is determined.

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The above article is reprinted with permission from the Louisiana Office of Financial Institutions. It was included in a May 16, 2007 update letter to Louisiana state-chartered banks.

THREE COMMUNITY BANKS APPLY FOR VIRGINIA CHARTERS

The Bureau has received three applications for certificates of authority to commence banking business: Community Capital Bank of Virginia, Christiansburg; First Virginia Community Bank, Fairfax County; and Frontier Community Bank, Waynesboro. The proposed banks also filed applications for federal deposit insurance and membership with the Federal Reserve Bank of Richmond. The applications are being reviewed jointly by the Bureau and the federal agencies.

Community Capital Bank of Virginia is being organized in response to a mandate from the Virginia General Assembly. In 2005, the General Assembly voted to allocate

seed funding for the creation of a state-wide community development financial institution (CDFI). The CDFI would provide a high degree of leveraging for economic development and housing activities within distressed communities throughout the Commonwealth. These activities may include mortgage financing for first-time buyers, financing for needed community facilities, commercial loans and investments to start or expand small businesses, loans to rehabilitate rental housing, and financial services needed by low-income households and local businesses. The CDFI also may provide services to help ensure credit is used effectively, such as technical assistance to small businesses and consumer credit counseling.

GUIDANCE ON LOANS TO EXECUTIVE OFFICERS AND DIRECTORS

Section 6.1-62 of the Code of Virginia sets forth criteria on loans to executive officers and directors.

Since credits of this nature should be of the highest quality, they typically will not earn an institution the best rate of return. In addition to compromising the return on assets, if an institution loans insiders more than a reasonable percentage of capital, the community might conclude that the insiders are running the institution for their own benefit, rather than for the benefit of the community.

Generally speaking, when these extensions reach 40% of equity capital, a notation on the level of insider debt will be included in the examination report. When an institution has 60% or more of equity capital outstanding to its insiders, the institution should notify the Bureau in writing.

Given the diversity of institutions and communities within the Commonwealth, circumstances may justify higher levels of insider debt. Accordingly, proper notification to the Bureau is necessary to ensure appropriate regulatory oversight.

Summary of Operations of the Bureau of Financial Institutions 2006, a new publication, is on the Bureau's website at <http://www.scc.virginia.gov/bfi/>

It provides valuable information about the activities and structure of the Bureau and the industries it regulates. A limited number of hard copies are available; copies may be requested by calling Katrina Lewis at (804) 371-9695.

THE BUREAU'S POSITION ON REGULATION O AMENDMENTS

Section 601 of the Financial Services Regulatory Relief Act of 2006 eliminated several statutory reporting and disclosure requirements relating to insider lending by insured depository institutions. The statutory amendments eliminated:

- the requirement for a bank to include a separate report with its quarterly Reports of Condition and Income (Call Report) on any extensions of credit the bank has made to its executive officers since its last Call Report;
- the requirement for executive officers to file reports with their bank's board of directors whenever they obtain extensions of credit from another bank in an amount that exceeds the amount they could obtain from their bank; and
- the requirement for executive officers or principal shareholders to file annual reports with the institution's board of directors during any year in which they

have outstanding extensions of credit from a correspondent bank of the institution (FFIEC 004).

The amendments did not change the substantive restrictions on loans by depository institutions to their executive officers and principal shareholders or loans to depository institutions' executive officers and principal shareholders by their correspondent banks. Conforming amendments to Regulation O were subsequently adopted by the Federal Reserve Board.

Reports detailing large executive officer lending relationships at other banks as well as reports detailing borrowing relationships of executive officers and principal shareholders at correspondent banks are useful tools for the board. It is essential that insiders maintain their financial dealings in a sound manner and beyond reproach. It is important for boards to ensure the financial condition of officers is sound, and directors should be especially mindful of correspondent bank balances when officers,

directors, or principal shareholders are borrowing from a correspondent bank. The Federal Reserve Examination Manual indicates that "the U.S. Department of Justice's position is that certain interbank deposits connected with a loan to officers, directors, or shareholders of the depositing bank might constitute a misapplication of funds in violation of 18 U.S.C. § 656."

The Bureau strongly encourages boards to consider continuing to require (1) executive officers to file a report with their bank's board whenever they obtain extensions of credit from another bank in an amount that exceeds the amount they could obtain from their bank; and (2) executive officers and principal shareholders to file annual reports with the institution's board during any year in which they have outstanding extensions of credit from a correspondent bank of the institution. We will continue to review this information, when available, as part of each examination.

IMPORTANT TELEPHONE NUMBERS

- Banks and Savings Institutions (804) 371-9704
- Consumer Finance and Mortgage Companies (804) 371-9701
- Licensing (applications, name changes, annual reports) (804) 371-9690
- Consumer Complaints (804) 371-9705
- Corporate Information (SCC Clerk's Office) (804) 371-9733
- Bureau's FAX number (804) 371-9416
- TDD (804) 371-9206

*State Corporation Commission
Bureau of Financial Institutions
1300 East Main Street, Suite 800
Post Office Box 640
Richmond, Virginia 23218-0640*



Check out our website at
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