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The Virginia State Banker

Regulatory news for Virginia State-chartered Banks

E.J. Face, Jr., Commissioner
Bureau of Financial Institutions - State Corporation Commission

NEW FDIC DIRECTOR CURRY SWORN IN

Flanked by family and friends, former Massachusetts Commissioner of Banks Thomas J. Curry was sworn in January 12, 2004 as the fifth member of the board of the Federal Deposit Insurance Corporation (FDIC). Curry, a past chairman of the Conference of State Bank Supervisors (CSBS), fills the long-empty seat specifically designated for a person with state regulatory experience. With the addition of Curry, the FDIC Board will operate at full strength for the first time in five years.

In attendance for the ceremony were CSBS Chairman Mick Thompson of Oklahoma and Chairman-elect John Allison of Mississippi, plus Commissioners Steve Antonakes of Massachusetts, Joe Face of Virginia, Robert Glen of Delaware, Kevin Lavender of Tennessee, and Randall James of Texas. Curry joins another former CSBS chairman, Office of Thrift Supervision Chairman James E. Gilleran, on the FDIC Board.

"Tom is a top-notch regulator and good friend," said Commissioner of Financial Institutions E.J. Face, Jr. "It is extremely important that we state bank regulators now have a voice on the FDIC Board, since the vast majority of the nation's 6,000-plus state-chartered banks have the FDIC as their primary Federal regulator."

"Tom's 16-year tenure with the Massachusetts Division of Banks makes him highly qualified for this important post," said Commissioner Face. Before joining the banking department, Curry was an attorney with the Massachusetts Secretary of State. Curry earned his bachelor's degree from Manhattan College and his J.D. degree from the New England School of Law.

ADMINISTRATIVE LETTER BFI-AL-1610 PREPAYMENT PENALTIES IN ALTERNATIVE MORTGAGE TRANSACTIONS

Prior to December 18, 2003, the Bureau was subject to an injunction entered by the United States District Court for the Eastern District of Virginia, Richmond Division. That injunction barred the Bureau from enforcing Virginia law limits on prepayment penalties in "alternative mortgage transactions" (AMTs) entered into by nondepository housing creditors. On December 18, 2003, the parties to the case in which the injunction was issued appeared before the Court to be heard on certain motions.

After argument, the Court ruled that the Bureau was not barred from enforcing Virginia law prepayment penalty limits with respect to AMTs entered into on or after July 1, 2003, the effective date of revised regulations of the Office of Thrift Supervision. Therefore, the Bureau will resume enforcement of those laws in connection with AMTs closed on or after July 1, 2003 by mortgage lenders licensed under the Virginia Mortgage Lender and Broker Act.

Issued by the Commissioner of Financial Institutions on February 18, 2004.

Reference: §§6.1-330.83 and 6.1-330.85 of the Code of Virginia

The Virginia State Banker is published quarterly 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 gsandler@scc.state.va.us.

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LESSONS LEARNED (AND TAUGHT) continued
By Harry Rowlett, Professor Emeritus

This is the second installment of a presentation by Harry Rowlett at the Virginia Bank Directors' College. He has given us permission to reprint his presentation in this newsletter.

The lesson continues…

HISTORY OF A BANK IN A MINING AREA

What I have described to this point is the culture of banking and attitudes of people in the most western town in Virginia—a farm community in Lee County—20 miles east of Middlesboro, Kentucky.

I will now discuss the case history of our bank, located in the eastern section of Lee County, in a mining area, 25 miles east of the agricultural community I previously described.

This discussion will illustrate how and why our bank developed a crisis situation in the mid-1970s that should and could have been avoided.

This case history demonstrates the necessity for organizational control and planning for the unexpected.

As previously indicated, I do not consider myself a "real banker." I am a lawyer who "got caught sitting" on a board of directors at the wrong time in the middle of a crisis situation. Thus, the beginning of my long career in banking.

The Bank had performed satisfactorily in normal times when very little business was in progress. However, it was totally unprepared for sudden change. The coal boom of the early 1970s caused sudden asset growth from $10 million to $40 million.

- The majority of the board of directors was made up of elderly men, who were nominally involved. These were men of character and integrity. They relied solely on the judgment and efforts of the CEO, who made all decisions.
- The board assumed no responsibility for organization, planning, audit, or controls. There was no backup management.
- The organization was unable to properly utilize this sudden increase of $30 million in assets.
- This resulted in deterioration in the loan portfolio to the point that the capital ratio was at an unacceptable level for the regulators.
- To further complicate matters, the CEO developed health problems and, on advice of his doctors, went on extended sick leave.
- All my assets, at that time, were invested in stock in this bank.
- It was under this crisis situation that I was made vice chairman of the board and organization director, with broad and general authority to organize the bank for survival. It was at this time that I fully understood how difficult it would be to plan.
- "How to drain the pond when you are up to your hips in alligators." That's not the exact quote, but I'm sure you get the idea of what our situation was at that time.
- To further complicate matters, other local businessmen analyzed the situation and opened two new banks and a branch of an existing bank in our sacred trade area.
- It was under this crisis situation that I gained some knowledge and experience in the management of a community bank "out of control." I do not recommend this method of learning the basic principles of banking.

IMPORTANCE OF CONTROLS FROM BANKER'S PERSPECTIVE

First, I contend that controls are equally important to everyone involved in, or served by, a bank. Second, I contend that organizational controls are designed to avoid crisis, rather than correct crisis.

- Controls are not just designed to inhibit management.
- Auditors and examiners alone cannot prevent crisis.
- I contend that appropriate controls can only be effective in a well-organized bank, in which all participants clearly understand their responsibilities, and understand and respect the responsibilities of others. Organizational controls can be compared to a "neighborhood watch" designed to prevent crime.
- I contend that the CEO derives the most practical benefit from proper organization and control.
- The CEO is the person we depend on to produce. This requires focus and undivided attention.
- Organizational control allows the CEO to focus on his/her primary duty to implement a strategic plan and make a profit, all within laws and regulations.
- This makes everyone happy, even the regulators.

RISK AND JUDGMENT

There is an inherent risk involved in banking.

- Acceptable risk - which the bank can afford and get paid for
- Unacceptable risk - chance of loss greater than the benefit to be derived
- Gambling - not acceptable when using other people's assets

Bankers are required, legally and ethically, to use reasonable judgment in their decision-making. I suggest that this judgment should be a collective and cooperative effort in an organizational framework, which clearly defines who is responsible for what.

- The CEO is a very important leader in a bank organization. However, he/she is not, and should not be, expected to be a "rainmaker."
- The chairman of the board is also a very important leader in the bank organization—with responsibility of organizing and leading the board to perform its monitoring function.
- The chairman of the audit committee and the internal and external auditors are vital to safe and sound bank operations. They must answer only to the audit committee and board.

(continued on page 3)

LESSONS LEARNED (AND TAUGHT)

(continued from page 2)

How should the responsibility and authority be distributed in a bank organization? I suggest that the best results are produced when each participant in a bank organization understands his/her individual function and authority, and respects the function and authority of other participants.

A well-defined communication system is essential. In my opinion, this can best be accomplished in a written organizational plan, which clearly defines the duties and authority of the board of directors, executive and management officers, and auditors. It should also include the bank's strategic plan, which clearly sets forth the bank's objectives, and indicates who is to do what to reach these objectives.

I fully recognize community banks come in many forms, with individual factors which require different organizational approaches. I have not found an organizational plan which fits all situations. Thus, some common-sense judgment is required to accommodate various circumstances. However, we can find some common principles which are appropriate for most situations.

Any combination of executive management and directors, which constitutes a majority of the board, amounts to a "beneficent dictatorship" or, at best, an obligarchy. Such combinations can result in an ineffective board and can potentially result in abuse of power, or special privilege, which is legally unacceptable in the current corporate governance environment.

Appropriate relationships between executive management (CEO) and the board (chairman) is essential. The Board is responsible to set policy, and then to hire management to implement that policy in the daily operation of the bank. Directors should not involve themselves in management.

The Board should elect or approve board committees to monitor and to maintain oversight of management to verify that policy is being carried out and laws and regulations are being complied with. It is essential that a majority of the board qualify as "independent" or "outside directors." In substance, to be "independent" the director must not be controlled, directly or indirectly, by management or be compensated for management duties.

- If the CEO, or any other individual or combination of individuals, controls a majority of the board, there can be no effective oversight or monitoring of management.
- A special challenge exists when directors are also a part of executive management.
- It is very difficult for an executive management officer to make management decisions and then as a director to objectively monitor those decisions.
- Appropriate organization requires that "independent" directors be assigned to the executive committee, audit committee, compensation committee, and nominating committee.
- The lessons learned from the Enron scandal and other corporate failures and the reaction by Congress in the passage of the Sarbanes-Oxley Act shouldn't be surprising.
- I see nothing about the act or regulations that appropriate corporate governance, ethical business practice and common-sense judgment would not require.

I would suggest that successful organization requires adherence to these basic concepts and procedures.

- My interpretation of the objectives of recent legislation is to require organizational structure that ensures checks and balances between active management and boards of directors, and independent verification by auditors and regulators.
- The need for this type of legislation has been clearly shown by Enron and other corporate failures.
- Incentive to produce is good, so long as there is a bridle on self-interest.

CONCLUDING REMARKS

- As a banker, you are in a trust relationship with your customers and with the reputation of the organization you represent.
- This requires ethical conduct in all your actions, which is above reproach. There is no room in banking for self-dealing.
- You are still considered among the most important individuals in the community, which is a status worth protecting.

It has been my pleasure to share with you my observations of appropriate banking from the past to the present. I trust younger and keener minds to deal with the challenges and complexities of appropriate banking in the future. I highly recommend that you continue your education in banking through active participation in the Virginia Directors' College seminars.

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Mr. Rowlett is Senior Executive Officer of Lee Bank & Trust Company in Pennington Gap, Virginia. The Bureau appreciates his generosity in letting us reprint his speech given at the May 2003 session of the Virginia Bank Directors' College.

SURGE IN APPLICATION FILINGS CONTINUOUS

The Bureau of Financial Institutions experienced another record year in application filings for various certificates of authority and licenses. In 2003, the total number of application filings increased to 2,796 compared with 2,418 in 2002 and 1,325 in 2001. Thus, application filings more than doubled over the last two years.

According to Deputy Commissioner Nick Kyrus, the continuing expansion of the mortgage industry and the regulation of payday lenders are responsible for the application surge. Mortgage lender/broker application filings increased from 2,030 in 2002 to 2,277 in 2003. In addition, the Bureau received 276 applications from payday lenders in 2003 compared with 167 in 2002. At the end of 2003, the Bureau regulated 1,899 financial institutions and licensees compared with 1,556 at the end of 2002.

The Bureau's Corporate Structure and Research Section is responsible for processing applications of both depository and nondepository financial institutions including banks, credit unions, money transmitters, consumer finance companies, nonprofit debt-counseling agencies, industrial loan associations, check cashers, payday lenders, and mortgage lender/brokers. Depository institutions filed 133 applications while nondepository institutions filed 2,663 applications in 2003.

A breakdown of applications filed by banks and trust companies is shown in the table below. As the table shows, in 2003 the Bureau received 125 applications from banks and trust companies. The great majority of the applications were for branch expansion (85) followed by acquisitions (15) and mergers (9).

Application Filings by Banks/ Trust Companies for 2003

New Banks	4
Bank Branches	85
Relocations	10
Acquisitions	15
Mergers	9
Trust Offices	2
Total	125

Despite the filing of four new bank applications in 2003, the number of banks regulated by the Bureau fell from 95 at the end of 2002 to 89 at the end of 2003.

NEW BANK APPLICATIONS

On March 4, 2004, MainStreet Bank received approval from the State Corporation Commission to begin banking business in Herndon, Fairfax County, Virginia. MainStreet Bank also has applications pending with the FDIC for insurance of accounts and with the Federal Reserve Bank of Richmond for membership in the Federal Reserve System.

MainStreet Bank proposes to begin business at 727 Elden Street in Herndon, Fairfax County, Virginia with $12.4 million in capital. The proposed Chief Executive Officer will be Jeffery W. Dick. The Board of Directors will consist of these 11 individuals: Barbara D. Blums, Chairperson; Jeffery W. Dick; Frank M. Alston; Thomas J. Chmelik; William A. Gatz; Darrell R. Green; P. Thomas Haddock; Kevin T. Keyes; Jacqueline L. King; Edward E. Merrow; and Donna M. Miller.

The Bureau of Financial Institutions is also processing the application of River City Bank for a certificate of authority to begin business at 6127 Mechanicsville Turnpike, Mechanicsville, Hanover County, Virginia. It proposes to begin business with $9.3 million in capital. The proposed Chief Executive Officer is William D. Stegeman. The Board of Directors will consist of these 13 individuals: Michael A. Katzen, Chairman; William D. Stegeman; Timothy C. Bishop; Dr. William C. Bosher, Jr.; Elwin W. Brooks, Jr.; Leonard T. Bukoski; Paul H. Connors; O. Woodland Hogg, Jr.; Linda H. Marks; Gregory S. Nevi; Joseph H. Seipel; Charles E. Walton; and John T. Wash, Sr.

River City Bank also has pending applications for FDIC insurance of accounts and for membership in the Federal Reserve System. Currently, there are 88 State-chartered banks regulated by the Bureau.

BEWARE OF ON-LINE BANKING SPOOFS

Secure socket layer (SSL) is the most common standard used by financial institutions to secure their on-line banking products. It has now been proven that SSL can be spoofed or used to imitate a legitimate company, i.e. your bank. This recently happened to the FDIC. E-mails were sent to people that appeared to come from the FDIC and provided a Web link in the e-mail that also appeared to go to an FDIC Web site. The user was then requested to supply personal data and bank account information. The Web site had the same address as the FDIC, and the Web page looked like the FDIC Web page in every way. However, the pages were actually running on a Web server in Russia. This has already happened to a bank in Australia. This is reportedly caused by a vulnerability in Internet Explorer that allows attackers to disguise Web addresses.

We are not aware of any way to prevent this aside from being sure your customers know you will <u>never</u> e-mail them for passwords or account information and by monitoring your system for unusual activity.

QUORUM FOR BOARD OF DIRECTORS

Pursuant to §6.1-45 of the Code of Virginia, a bank must have at least five directors on its board. Furthermore, §6.1-52 of the Code of Virginia permits business to be lawfully transacted by as few as five directors (provided such number is approved by the shareholders and set forth in the bylaws). When read together, it is the Bureau's position that the Virginia Banking Act requires a bank operating with a board of five directors to have <u>all</u> of the directors present in order to lawfully transact business. If a bank has five directors on its board, allowing a majority (i.e., three directors) to lawfully transact business raises the possibility that the bank could be operated by just two directors. Apart from its interpretation of the referenced statutes, the Bureau would consider this to be an unsafe and unsound practice.

VIRGINIA BANK DIRECTORS' COLLEGES

<u>Second Session of Fall College Necessary</u>

On February 4 and 5, 2004, sixty-four participants convened at The Jefferson Hotel in Richmond for an overflow session of the fall Directors' College. Billed as the "new" directors' session, the fall college agenda focuses on director responsibilities, understanding regulatory examination and supervisory activities, and some practical aids and sources of information for directors. The extra session was scheduled after the November session filled quickly and a substantial waiting list developed.

Once again, representatives from the Federal Reserve Bank of Richmond and the FDIC were on hand to make presentations, assist in activities, and be available to discuss issues during breaks. Mr. David Baris, Executive Director of the American Association of Bank Directors, was also on hand.

Directors report that sometimes as important as the formal presentations at the Directors' College are, also important are the opportunities to discuss questions, points of interest, or particular circumstances with regulators at breaks and social times. The Bureau has also found great value in getting a better understanding of directors' concerns and perspectives through these individual discussions. We also appreciate the assistance and level of commitment the Federal regulators provide to the College, which helps make the individual attention possible.

<u>Spring Directors' College Offered in Two Locations</u>

The Virginia Bank Directors' College—Emerging Issues Session will be held at the Boar's Head Inn, Charlottesville, on April 21 and 22, 2004 and at the Martha Washington Inn, Abingdon, on May 19 and 20, 2004.

Registration is being handled by the Virginia Association of Community Bankers. Contact the VACB at (804) 217-8250 if you have questions. The program brochure was mailed the first week of March. Sign up early; registration is limited.

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

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