BLAST FROM THE PAST - CIRCA LATE 2002

by Steve Brown

We are having our annual banking conference this Monday, Tuesday and Wednesday. As such, the article in this section of the publication revisits an educational piece that we ran a few years ago. We will return again on Thursday and Friday of this week with fresh material, but in the meantime, please enjoy this blast from the past as you enjoy your morning coffee.

There are certain things in life that we are embarrassed about. The fact that it took mankind 128 years to figure out to produce a ketchup bottle that can stand upside down is one.

Ketchup first gained popularity during the recession of 1875 as a poor man's sauce (as horseradish was for the elite). That recession was caused by a run on banks that started after a collapse of real estate prices led to a rash of bad loans.

The problem then, as it is today, was that in many banks the board of directors approves the largest loans. In a majority of community banks, officers and/or the loan committee can approve loans up to some threshold, with the board approving anything above this number.

Similar to the traditional ketchup bottle, this makes no sense. Consider that in most community banks, the board is comprised mainly with a group of non-bankers. This group has the approval to make the bank's riskiest loans, while the professionals of the loan committee are relegated to lower approval status.

This tradition, combined with the fact that the board usually follows management's recommendations on most of the credits, only results in giving regulators and shareholders another set of warm bodies to punish should loan quality turn south.

The board, as with all facets of bank management, should act as a check and balance mechanism to ensure the safety, soundness and profitability of an institution. Assuming management has given the directors the tools and education to accomplish this task effectively, that makes perfect sense.

A board should also set and monitor policies, procedures and limits for bank management to follow. In addition, the board should approve and oversee bank activity.

The board should change management, limits or policies, but not approve individual loans. While talking about the "Jones" deal is interesting, a dentist is probably better providing guidance when a filling might be needed than the value of debt coverage or loan to value. A board that extends beyond this introduces the very risk that they are seeking to eliminate - namely poor loan judgment.

If part-timers override the decisions of full-time professionals, trouble invariably follows.

BANK NEWS

M&A

Village Bank and Trust Financial Corp. ($385mm, VA) will purchase River City Bank ($122mm, VA) for $20.2 million, or 1.3x book price (45% premium to current market). River City was started in 2004, failed to produce earnings last year, had high overhead expenses, was underleveraged in terms of capital, but was constrained by deposits for growth. Credit quality remained stable.

Countrywide Problems

The FBI launched an investigation this week into securities fraud at the Company. As a result rumors continue that BofA is renegotiating the price and terms of the acquisition.

TAF Auction

Because of the increase in liquidity, yesterday's Fed's TAF auction cleared at a 2.39% rate. In the past, the TAF Auctions have had rates 8bp or higher to Fed Funds.

Wachovia Pay

CEO and President, Ken Thomson's base pay remained unchanged at $1.09mm for 2008. Thomson saw no cash or performance based awards, but did earn option grants to the tune of $11.25mm as per contract. The Bank's earnings fell 19% in 2007 and the stock tumbled 33%.

CU Pay

The NCUA is proposing that Federal credit unions report annual compensation of their top executives to members similar to state credit unions and public companies. The NCUA has come under pressure as of late that Federal CU's lack transparency in operations.

ACH

The Fed proposed that it align their ACH and debit transfers posting times. The proposal includes moving earlier the times from 11am ET to 8:30am ET. This would align posting times for commercial and gov't ACH transfers.

Citi Losses

The Bank disclosed that traders racked up more than $100mm of losses on 15 separate occasions last year. Stating the obvious, Citi said that its risk management practices may need improvement.

UK Banks

Banking regulators in Britain warned that banks should stress their payment and settlement systems for "extreme events." As a rule of thumb, banks should be able 3x the current payment/settlement volume at a minimum.