THE community banker

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Crypto Chronicles:
Bitcoin 101 for Community Bankers

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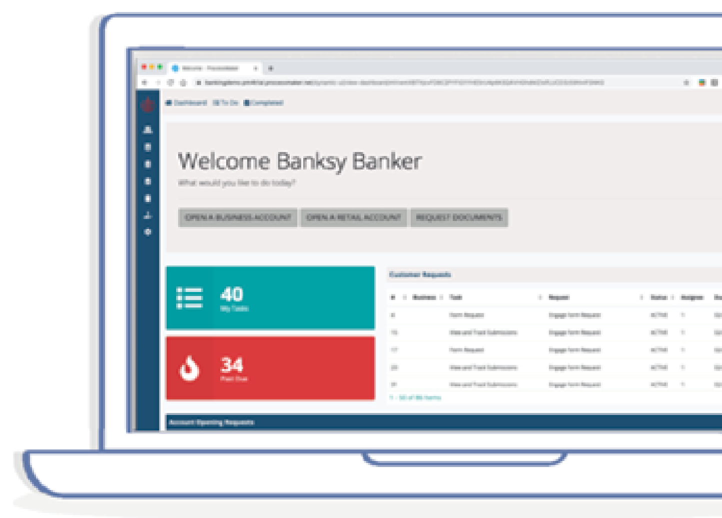

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That's all it takes to set off a damaging cyber attack.

Cyber attacks come in all shapes and sizes. A massive data breach was set off by a malicious virus that wormed its way inside a company's computer network. A bank's weeklong loss of access to its email and electronic records most likely began with a click.

Just think about the damaging consequences of this kind of intrusion. Since the average cost of a data breach has continued to rise, it's something your business should take seriously.

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Chairman's Message

By J. Michael Thomas
VACB Chairman
Select Bank, Forest

Dear Fellow Community Bankers,

With summer just around the corner, vaccination rates rising, and restrictions easing, everyone is looking forward to life, mainly returning to the pre-pandemic normal. Interestingly, a lot of what we miss so much now we would likely have considered mundane 16 months ago. The lesson here is to enjoy life in the moment. The truth is the COVID pandemic will forever change our lives, our businesses, our industry, and our country. Community Bankers have always found ways to meet the needs of their customers and communities during previous life-altering seminal events in the past. As always, we will Improvise, Adapt and Overcome, again.

Many bankers I've connected with over the past few months have posed the same question: What's next? With the promise that the pandemic is soon to be mostly behind us, everyone is trying to predict the "new normal" and redefine strategies to thrive in a post-pandemic economy. As leaders in our families, businesses, and industry, it is incumbent on us to take the lessons learned and use them to move ourselves and our industry forward. To not take the easy path of returning to the comfortable but instead take this opportunity to continue to reimagine the customer experience and how we can meet our current customers and prospects "where they are." Over the past year, we have learned to become more agile and innovative. We will need to keep these skills sharp to build upon our pandemic success in serving our customers' needs. Innovation will remain a standout core competency critical for every bank's long-term growth and survival and not just technology advancements. While some will return to pre-pandemic ways of banking, we must continue to connect with our customers and actively listen to their needs to innovate and grow in the right direction.

Just as how we serve our customers' needs has changed, so too has the way we think about and meet the needs of our employees. No doubt this has been quite an uncertain time for employees everywhere. While being concerned with their health and the health of loved ones, their work lives were changing as well. Most of what they knew and how they operated changed nearly overnight. Community banks everywhere have developed a sharper focus on their employees' health and well-being across the board. The employee/company bond has been strengthened by promoting work from home and providing all the necessary tools to allow our employees to perform their jobs to a high level while ensuring the highest level of safety for all. Continuing to offer the benefits and flexibility our employees need will ensure we recruit and retain a staff that will grow with an ever-changing banking landscape.

I am confident we can continue our success by implementing innovative strategies to benefit our customers and our employees. Lean on your fellow banking leaders and the VACB for resources as we continue to serve our customers and communities well into the future successfully.

It truly is a great day to be a Community Banker!

J. Michael Thomas, Select Bank

President's Message

By Steve Yeakel, CAE
VACB President and CEO

The Past is Merely Prologue

Consider the valuable accomplishments of VACB bankers and associates over the last several weeks: an in-person four-hour leadership conversation; 100 VACB members enjoying the Spring Creek Golf Course and time with each other; and productive and engaging education sessions. It would be easy to take a couple of victory laps. But it's better to use these "high points" as rich fuel for the challenges that lie ahead.

That said, I want to celebrate the multiple wins for community bank advocacy in Virginia achieved through our "virtual Hill visits" in late April. In groups of all sizes, 40 bankers had good visits in 12 of 13 offices of the Virginia Congressional delegation. On the list of bankers were more than a dozen who participated in their first VACB/ICBA advocacy. Our visits with Senators Warner and Kaine were most productive, and meetings with Representatives Wittman, Luria, Cline, Spanberger, Griffith, and Wexton were lively and engaging. Discussions with senior staff in the other four offices were also productive. But in looking back at these events, it's clear that their success is not a box we check or a book we close; they're no more and no less than the next positive step in maintaining and enhancing critical relationships.

As for what lies ahead, the swinging pendulum in Washington is creating a list of issues that run clear off of our advocacy to-do list, and the changing financial environment gives us much to analyze. We face issues regarding what to do about cryptocurrency, diversity, cybersecurity, digital strategy, and much more: challenges galore.

But we have a growing reservoir of dynamic resources to call on, centered in a highly motivated cadre of volunteer leaders. Most importantly, we have bankers across the VACB membership who are leaders, strategists, and subject matter experts, all willing to commit their time and resources to find solutions and, just as importantly, share them.

Notice that I haven't used the "P-word" yet? That, too, with all its mostly terrible impacts on our world, is but prologue. We hear it all the time: it's not about what happens to us; it's about how we respond. The members and staff of VACB have created some great successes and experienced some significant hardship, but we are fixated on the tasks ahead and determined to thrive going forward.

Crypto Chronicles:

Bitcoin 101 for Community Bankers

By Brian Laverdure

The payments industry is abuzz with excitement as one topic continues capturing headlines, with profound implications for community banks: Bitcoin.

As the original digital currency, Bitcoin has steadily climbed from obscurity to reach a total market capitalization of over $1 trillion. However, the lofty valuations often come with steep declines — it is not uncommon for Bitcoin's value to rapidly plummet in a matter of hours.

With digital currencies reshaping the U.S. payments system that community banks and their customers depend on, what exactly is Bitcoin, and from where did it arise?

Origins of Bitcoin

The story of Bitcoin started in the murky corners of the internet on November 1, 2008. On that date, a person or group called Satoshi Nakamoto uploaded the original white paper that laid out the vision for a "purely peer-to-peer version of electronic cash" that would permit people to send payments without using financial institutions as intermediaries.

This new form of digital money depends on cryptography to secure transactions — thus, the word cryptocurrency was born.

Bitcoin launched on Jan. 3, 2009, when Nakamoto created the first transaction block, now known as the genesis block. The block contained a message reading "The Times 03/Jan/2009 Chancellor on brink of second bailout for banks" that serves as a timestamp and criticism of the traditional financial system and the Great Recession.

Shortly thereafter, the first transaction occurred on January 12 when Nakamoto sent ten bitcoin to Hal Finney as a test.

Nakamoto continued to support the development of Bitcoin until posting a final entry on the Bitcoin Forum on Dec. 12, 2010, and final communications to the crypto community in April 2011. Nakamoto, whose identity remains a mystery, has estimated holdings of 1.1 million bitcoin that have never been spent or transferred.

How Does Bitcoin Work?

Unlike the electronic payments that bank customers initiate with ACH or cards, Bitcoin transactions do not flow over traditional payment rails or require processing financial institutions to complete the transactions.

New Bitcoin is not created by any central bank but generated through a process called mining.

Bitcoin does not exist as a physical object. Images of golden coins stamped with various Bitcoin symbols are artistic representations to help viewers understand or visualize the abstract concept of cryptocurrency.

Miners are engaged in a 24/7 race to bundle unprocessed transactions into blocks to add to the public ledger of all Bitcoin transactions, known as the blockchain, to receive transaction fees and newly minted Bitcoin as compensation for their efforts to maintain the network. The network relies on miners to process and validate all pending transactions and, most importantly, prevent users from spending the same bitcoin twice.

Nakamoto devised a clever solution to achieve consensus across the decentralized network and ensure that transaction processing requires enough resources to disincentivize miners from confirming false records. Miners must complete challenging proof-of-work calculations that consume tremendous amounts of electricity to sustain sufficient computing power.

The proof-of-work equations become increasingly complex over time, necessitating more powerful computers and more electricity. Bitcoin's electricity use is now controversial with many critics, including Treasury Secretary Janet Yellen, calling it wasteful and harmful to the environment.

To initiate a Bitcoin transaction, an owner needs access to a Bitcoin address and a private key. The Bitcoin address, a hashed version of the public key, is similar to a publicly shared bank account number. The private key is comparable to an exclusive password.

These are critical elements of a process called public-key encryption that cryptographically secures all transactions. All the "electronic coins" associated with a particular address are a "chain of digital signatures" because the number of bitcoins contained within any address always derives from the outputs of previous transactions.

A new transaction occurs when the owner digitally signs a transaction message with their private key, proves ownership of bitcoin associated with the address, and secures the directive before broadcasting into the network for confirmation.

A private key should never be shared and should always be protected — losing a private key means losing access to bitcoin. Likewise, forfeiting one's keys to someone else risks surrendering control of one's bitcoin.

To initiate a Bitcoin transaction, an owner needs access to a Bitcoin address and a private key. The Bitcoin address, a hashed version of the public key, is similar to a publicly shared bank account number. The private key is comparable to an exclusive password.

There are many stories of lost fortunes due to forgotten passwords, lost hard drives, or hackers obtaining private keys to steal cryptocurrency. Researchers estimate that 20% of all created Bitcoin may be permanently lost.

The Evolution of Bitcoin

Expanded beyond its mysterious origins to become a complex force for innovation in financial services, Bitcoin will dramatically impact community bank operations.

There were an estimated 101 million unique crypto-asset users as of the third quarter of 2020, with four in 10 planning to use cryptocurrency within the upcoming year. Other announcements, such as Coinbase's initial public offering and PayPal's expanded cryptocurrency services, signify that the digital currency industry is advancing toward a new level of adoption and acceptance.

However, important questions remain unresolved, including whether Bitcoin possesses the attributes to qualify as money or is instead a speculative store of value. Resolving this question will directly affect the development of cryptocurrency policies and regulations.

I will continue to examine this question more closely in the coming months, along with more on direct implications of cryptocurrency on community banks. Meanwhile, don't forget to follow me on Twitter @brian_laverdure for more news and perspective on cryptocurrency.

Brian Laverdure, AAP, is Vice President, Payments and Technology Policy for the Independent Community Bankers of America (ICBA). In this role, he advocates payments and bank technology policy issues before financial regulatory agencies, private-sector organizations, and Congress on behalf of the nation's community banks.

2021 VACB / Williams Mullen — 21st Annual Bankers' Cup Tournament

As further evidence of our emergence from the COVID-19 pandemic, VACB sold out its 21st Annual Bankers' Cup Golf Tournament on May 4 at Spring Creek Golf Club in Gordonsville. Over 100 bankers and associate members gathered for a day of fun and fellowship on the green. The mood was electric and jovial, as golfers were glad to be together in a relaxed post-pandemic environment. This year's tournament was again co-sponsored by Williams Mullen, and 25 teams wasted no time getting to their spots for the shotgun start. While out on the fairway, players were well fed and hydrated, thanks to our supporting sponsors. Vining Sparks, an endorsed provider of ICBA, and the Federal Home Loan Bank of Atlanta graciously sponsored the beverage carts during the tournament, and Sentry Management provided boxed lunches. Many thanks also to Source4's, Meg Forsberg, who volunteered to be an honorary VACB staffer for the event! (We appreciated your help, Meg!) As the Spring Creek golf pro tallied up tournament results to determine the winners, golfers enjoyed food and fellowship at the post-tournament reception and meal, generously provided by new VACB Associate Member ProcessMaker. William Mullen's Scott Richter and VACB's Steve Yeakel awarded team and contest prizes. The 21st Annual Bankers' Cup tournament was a huge success once again, and we thank all our members for their support, both on and off the green! We could not do what we do without your help and support!

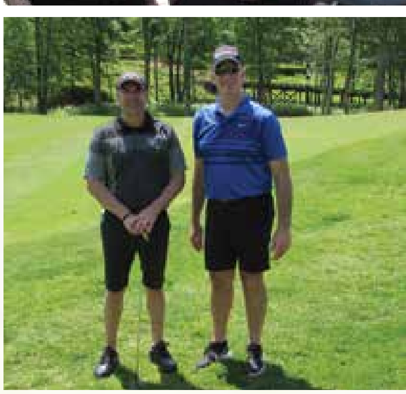
First Place Team
(Team Farmers Bank of Appomattox | Vining Sparks)
Bruce Drinkard, Todd Moore, David Perkins, McNeill Wells, Vining Sparks

Second Place Team
(Team Primis) Bruce Brockwell, Larry Henshaw, Joe Shearin, Bob Watts

Third Place Team
(Team Burke & Herbert Bank)
David Boyle, Joseph Collum, Carl Ford, Nick Greksouk

VACB Longest Drive Winner
Andrew Lane, BancCard

VACB Closest to the Pin Winner
Patrick Heijmen, Community Bankers' Bank



Munis For The Many

Taxable Municipal Bonds Have Appeal For Nearly All Community Banks

By Jim Reber

I have some good news for community bank portfolio managers who have grown weary of some or all the following conditions that have persisted since 2020:

- declining portfolio returns
- erratic cash flows
- call option exposure
- paltry yield spreads

Chances are your bank's portfolio was affected by some of these conditions over the past year. The wild ride in interest rates kept producing surprises for the bond portfolio, and, in truth, the only thing positive to be said is that prices rose — then declined — over that period. So, banks' positions lost value in 2021, but current investment yields improved, which illustrates the mixed blessing.

Over time, one of the enduring determinants of investment performance is sector weighting. More specifically, the more a bond portfolio consists of municipal bonds, the more likely it will have above-peer yields. According to Vining Sparks, as of Dec. 31, 2020, municipal bonds made up 53% of top-quartile community bank portfolios. At the other end of the spectrum, the bottom quartile was only 9% invested in munis.

Historically, the number of bank-owned munis primarily determines a bank's need to avoid tax liability. Some depository balance sheets have not had room for bonds, muni, or otherwise. Others have not been profitable enough to worry about that option. Still others, such as S Corps that pass earnings to shareholders, do not benefit from tax-free earnings.

Supply shift

Fast forward to the Tax Cuts and Jobs Act of 2017, which reduced corporate tax rates by around 40%. That was good news for bottom lines, but it lowered the effective yields on all tax-effected assets, such as traditional munis and bank-owned life insurance. Since that time, banks have shed about one-fifth of their tax-frees.

Another subtle but significant feature in that legislation was to no longer allow muni issuers to "pre-refinance" their outstanding debt into other, new tax-free issues. Refinancing older bonds into taxable matters would significantly impact the types of munis issued in the current environment.

In the 2020 calendar year, fully 30% of municipal bond issues were of the taxable variety, a decade-plus high-water mark. Less than 10 years ago, taxable munis were but a blip on the new issue screen. They would constitute somewhere between 3% and 7% of total new issuances. The only year taxable munis exceeded 2020's volume was 2010. And that was purely a function of the narrow window for issuing Build America Bonds (BABs), a type of taxable munis only available for issue in 2009–2010.

Crowd pleasers

Now to the afore-promised good news. If your community bank is not much invested in munis, taxables could bring some welcome relief to the issues mentioned in the first paragraph. As supply has grown and the interest rate curve has steepened throughout 2021, taxable munis can serve several purposes, not the least of which is a respectable return. An investor can also now realistically hope for an issue that is reasonably proximate to its footprint.

In the 2020 calendar year, fully 30% of municipal bond issues were of the taxable variety, a decade-plus high-water mark. Less than ten years ago, taxable munis were but a blip on the new issue screen. They would constitute somewhere between 3% and 7% of total new issuances. The only year taxable munis exceeded 2020's volume was 2010.

A high-grade general obligation taxable muni will out-yield a bank-qualified (BQ) issue at any point on the yield curve. As of this writing, a 10-year AA-rated BQ bond will have a tax-equivalent yield of about 1.85%, whereas a similar-duration taxable will be about 2.10%. There are many reasons, including the relative lack of supply of BQ paper. Also, it bears mentioning that if S Corp banks have tax-free income, they may recognize higher tax-equivalent yields than their C Corp brethren.

What is the downside? As with any other taxable security, municipal bonds will have a higher degree of price volatility than tax-frees. However, the additional price risk is less than it used to be back in the era of 36% marginal rates for C Corps. It is unknown what the impact of higher marginal tax rates will be on the tax-free muni market, but higher rates should be supportive of tax-effected assets.

In the meantime, the growing supply of taxable munis should continue to produce attractive yields. The amount, both in absolute dollars and for a given issue (which is not limited to $10 million per issuer per year that BQs are), should produce more than adequate liquidity. The benefits and availability of taxable munis should appeal to the many community banks looking for the right combination of risk and reward.

Jim Reber (jreber@icbasecurities.com) is president and CEO of ICBA Securities, ICBA's institutional, fixed-income broker-dealer for community banks.

The Difference Between Vendor Significance and Vendor Risk

By Leticia Saiid

It can be tricky to separate the concepts of risk and significance when it comes to vendor management. Are they just two paths saying the same thing? Does one depend on the other? How does due diligence play into those ratings? If you have asked those questions before, or if this is your first time to see them, you have come to the right place. Let us explore this idea.

First, define vendor significance. Significance is about how much you rely on the vendor. How significant are they to your operations? A vendor could be insignificant, influential, or even critical. For example, a vendor would be vital if you needed their services for your business to survive, like your core provider. A vendor would be insignificant if their failure would have minimal effect on your business, such as your office supplies vendor. You could get by with help from Amazon or Walmart until you have a new vendor in place.

Next, define vendor risk. When talking about risk rating relationships with vendors, we often hear the question, is it inherent risk or residual risk? I believe it is neither. When it comes to your vendors, what you are looking at is transferred risk. Transferred risk is not the level of risk the vendor has before they apply controls, and it is not even the level of risk the vendor has after implementing them. Some people may describe the due diligence process as applying controls, and so feel like the risk level selected is residual after getting and reviewing those documents. Not at all. Instead, combined with vendor significance, due diligence is what provides you an accurate representation of transferred risk. It is the risk your bank is taking on by being in a relationship with the vendor, as-is. However, if needed, there are other measures you could pursue to reduce the transferred risk, such as specific insurance or requesting the vendor gain necessary certifications.

One thing to note is that significance and risk are not necessarily correlated. Imagine an insignificant vendor, perhaps an office cleaning service. Insignificant because (1) there are many companies from which to choose, and (2) if you had to go without the service for a few days, it would not be particularly harmful to the bank. At the same time, from a security standpoint, this vendor could be considered a high risk. Their staff has more access than the average person to your documents and assets. If allowed access to bad actors or shared proprietary information, that could cause a lot of damage. There is a high risk, even though the vendor is insignificant.

Here is what it looks like when we put all the pieces together. First, you determine significance by considering: if the vendor were to have a breach, be temporarily unavailable, or be permanently unavailable, would that be a problem for us? If so, they are significant or maybe even critical, depending on your criteria.

Then, you can get more specific with those problems to determine what due diligence documents would be valuable to review. Here are a few examples.

- If the vendor were to have a breach and that would be a problem, we need to review their SOC Audit Report to confirm they are considered secure by a qualified third party.
- If the vendor was temporarily unavailable, thereby creating a problem, we need to see enough of their BCP or SLA to make sure they have plans to keep our service moving.
- If the vendor was to go out of business, thereby creating a problem, we need to see their financials to confirm it looks like they will last a while.

If these conditions are not problems for us, we do not need to look over, or even gather, the related documentation because it will not tell us anything we need.

When talking about risk rating relationships with vendors, we often hear the question, is it inherent risk or residual risk? I believe it is neither. When it comes to your vendors, what you are looking at is transferred risk.

Finally, knowing how significant the vendor is and knowing how stable and prepared they appear to be, based on the data in their due diligence, we can accurately define the transferred risk we are getting into by being in a relationship with the vendor.

After earning a B.A. and an M.A. in Mathematics, Leticia joined CoNetrix, where she served as the Tandem Software Support Manager for several years. She built and directed Tandem's first team of support specialists. Leticia now serves as Chief of Staff, focusing on corporate strategy, employee development, and training. In her free time, she enjoys mentoring college students, teaching phonics, and solving jigsaw puzzles.

Tailoring Your Fair Lending Program to Address Regulatory Trends and Institution-Specific Risk

Fair lending has been a focus of regulators for several years. Consequences of non-compliance can be devastating to a bank, as formal regulatory action can often bring significant fines, penalties, attract negative attention and potentially stall mergers and acquisitions. As the world around us continues to change, institutions that commit to performing data-driven fair lending reviews can expect to receive dividends from their efforts for years to come.

Historically, fair lending reviews have primarily focused on ensuring borrowers received equitable treatment, regardless of gender, race and ethnicity. Procedures usually consist of policy reviews, an analysis of approval/denial rates by protected class and a comparative file review. While these procedures make for a strong foundation, institutions should assess whether they address all inherent risks based on their operational structure and product offerings. To ensure your review program is up to par, institutions should first consider conducting a fair lending risk assessment to accurately understand and prioritize risks. Because fair lending risk exists at every stage of the lending process, institutions should evaluate risk for all lending stages and all loan types. Institutions should also consider each of the following:

1. Loan Segments: are all segments and their unique risks being reviewed?
2. Basis of Discrimination: are all bases — beyond the big 3 (gender, race, ethnicity) — being reviewed?
3. Tailored Approach: is our review targeting our institution's specific risk areas?

Loan Segments

Many institutions have traditionally focused their efforts on HMDA (Home Mortgage Disclosure Act) reportable loans. The HMDA data set is a great starting point as it includes all applications, physical addresses and vital demographic information. Unfortunately, on average, these loans typically represent only a portion of an institution's loan portfolio, leaving most loans untested. Recently, regulatory focus has increased around this issue, with institutions receiving comments related to their monitoring of non-real estate, indirect and purchased loan segments.

Generally, to ensure no systemic fair lending issues lurk in an institution's blind spot, all segments should be evaluated. Reviewing non-HMDA segments can be a challenge as most institutions do not collect demographic information on their applicants. However, by using publicly available data sets, institutions can synthesize much of the demographic information necessary to perform an adequate analysis.

The Social Security Administration publishes all baby names occurring more than five times annually.[1] The list includes the name given, the gender, and the number of times it was registered. Applying this data, a "most likely gender" field can be synthesized, giving an institution the ability to review and analyze these segments for inconsistent lending practices based on gender, just as they would for HMDA reportable loans. Similarly, through their website, the United States Census Bureau (USCB) publishes a listing of all surnames occurring more than 100 times.[2] Each name listed includes a total count and the percentage breakdown of how frequently the name was associated with each of the ethnicities captured in the UCSB's canvassing process. Institutions can use this information to synthesize a "most likely ethnicity" field to evaluate these segments based on ethnicity. While this approach is less accurate than collecting data from the borrowers directly, it provides institutions with an opportunity to assess these often-neglected segments.

Basis of Discrimination

As noted, fair lending reviews have historically centered around three main classifications of borrowers: gender, race and ethnicity. However, there are many more bases to consider when performing a review based on applicable regulations. Traditionally, financial institutions have focused on preventing discrimination based on race. However, most cases often relate to facts other than race. Such findings included marital status, familial status and age discrimination, indicating that the traditional focus of reviews may no longer be sufficient.

Examiners have identified trends where married borrowers are often granted preferential treatment during approval and underwriting. Namely, when a single borrower with a co-signer applies for a loan, many institutions use the primary borrower's credit score regardless of whether it is higher or lower than the co-borrower's score. Contrarily, married couples who apply (as borrower and co-borrower) often benefit by having the highest credit score selected. In this scenario, where both sets of borrowers apply as primary and co-borrower, the only differentiating factor is their marital status. Therefore, inconsistent treatment of the two groups is clear discrimination based on marital status.

Fair lending guidance states that a creditor cannot consider an applicant's age when making a credit decision except that they are of age to enter a legally binding contract. Specifically, borrowers who are 62 years of age or older must be treated equally to those borrowers under 62. Automatic loan approval is one area where age discrimination has been identified, where the borrower's age is treated as a reduction in the determination of their creditworthiness. Including age in a judgmental loan evaluation system violates guidance from both ECOA (Equal Credit Opportunity Act) and Regulation B.

Unlike the big three, marital status and age are data points primarily available across all segments of the loan portfolio. By analyzing your portfolio based on these data points, it is relatively simple to gain comfort that borrowers are not discriminating based on marital status and age.

Tailored Approach

To maximize the effectiveness of your fair lending review, it's always best to start with an analytical approach. Doing so allows you to create a risk-based approach to identifying abnormalities that may require further investigation. When performing this analysis, think beyond approval and denial rates and consider analyzing your portfolio on other areas of borrower engagement for all bases of discrimination. Just a few examples include:

- Pricing compared to creditworthiness
- Pricing exceptions granted (frequency)
- Pricing exceptions granted (dollar impact)
- Time to close
- Loan fees

Managing risk is making sure that problems do not happen in your institution. By combining the insights gained from your data-driven approach and identifying and measuring fair lending risks associated with processes and monitoring mechanisms, your institution will be well on its way to a more robust fair lending review and the peace of mind that comes with it.

We Can Help

If you would like more information about tailoring your Fair Lending Program, please reach out to Alek Bevensee, Austin Ramsey, or a professional in our Financial Services Group practice.

[1] Available through ssa.gov and data.gov
[2] Available through census.gov

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Alek is a Manager in Elliott Davis' financial institutions group. As a thought leader on data analytics and emerging technologies, he has authored commentaries, presented at industry conferences and guest lectured college courses. His recent focuses include enhanced monitoring of loan portfolios (credit, compliance and operational risk), aiding companies with data-intensive calculations, and working with clients to quantify and remediate multimillion-dollar errors related to the administration of their employee benefit plans.

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