

Starting an RF Bank in the United States

Acquiring and Restructuring a Troubled Bank and Operating It Riba-Free

INTRODUCTION

This chapter covers the efforts we went through to acquire and operate a full service bank in the United States. This chapter is a must for anyone who may be interested in buying and operating a bank in America. It is also a useful step-wise discussion that should benefit those who want to restructure a troubled bank and bring it to a healthy and a profitable condition. Finally, this chapter is important for those who are interested in operating a riba-based bank in America and the West in a riba-free (RF) format without having to go through the lengthy and expensive process of trying to obtain exceptions from the regulators. As was stated earlier in the book, RF banking is not about changing words and using circumventive techniques to make the contracts “compliant” with the Law (Shari’aa). RF banking is a new brand of banking that applies the spirit and substance of Judeo-Christian-Islamic values. It is about the use of principles that would save the consumer and the businesses from participating in an economic bubble like that of 2008.

One of the options we considered in 1987 when LARIBA was started was to organize it in the form of a depository institution (meaning a bank). We reasoned that this option would offer us the ability to take deposits and to offer insurance on deposits through the Federal Deposit Insurance Corporation (FDIC). However, we knew nothing about the business of starting a bank in the United States. We were told by many of our friends that the process of starting or buying an existing bank is called change of control of

that bank. Acquiring an existing bank is an expensive, involved, and lengthy process. In addition, it requires the organizers to be well-known to the banking regulators and the founding shareholders to have sufficient capital. As detailed earlier, we did not satisfy many of these prerequisites:

- We did not have a lot of capital.
- We did not have a lot of money to spend on pre-organization and pre-operating expenses, such as legal, organizational, administration, and application fees and expenses.
- We were not known to the regulators; we were offering a new brand of banking which at the time was foreign to all people. For that matter, the RF banking and finance system was not only foreign to the banking regulators but also to Muslims and non-Muslims in general.

We simply did not know where to start.

That was why we started by licensing LARIBA as a finance company regulated by the State of California Department of Corporations.

After operating for almost three years and interacting with customers and users of our services, many of our customers and community members indicated that they would love to transfer their bank deposits to us, but they could not, because deposits at LARIBA are not insured as in banks by the FDIC. We told them that we, at LARIBA, could not accept deposits anyway, because LARIBA is not a U.S. government-chartered depository institution; it would be illegal for us to accept deposits. However, this thought planted the seed of the idea of owning a full-service bank in the United States that would serve the community in an RF mode. The dream we had was to start or buy a bank that would eventually be operated according to Shari'aa while upholding the laws of the land.

Our strategic vision was to design this bank to serve people of all faiths, and not Muslims only. That is why, later on, when we developed the bank, its advertisement, its business development campaigns, the Internet site, and the presentations we gave were all designed for all people of all faiths. In our focus groups, people in the community were asked a simple question: "Would you prefer to go to a small crowded Asian or Middle Eastern store? Or to go to a large, clean, well-stocked and -organized supermarket that offers international foods?" The answer has always been the supermarket.

Another important strategic decision made was how to present our services. Many others that came to the market focused only on the Muslim community. We decided to focus on the United States first, and hopefully the world. Calling something Islamic does not necessarily make it so. It is the way one conducts business, deals with people, and conducts his or her life that defines who that person and that institution is. Calling a model of

financing by a “foreign” name does not make it Islamic; what makes it Judeo-Christian-Islamic is the substance and spirit by which it offers unique and measured advantages over other conventional banking models. In summary, we made sure that we do not “wear our religion on our sleeves.”

BENEFITS OF OFFERING AN RF BANKING ALTERNATIVE IN AMERICA

1. It applies the strict conventional U.S. banking regulatory and supervisory environment and practices enjoyed by U.S. banks to RF banking practices, products, and services. This adds more credibility to the RF banking approach and will make its product more reliable and acceptable in the market.
2. It creates a larger pool of bankers of all faiths, training, and experience who are well-versed in both conventional riba banking and RF banking. This will bring a large pool of banking experience, expertise, and creative abilities to manufacture new products and services for the RF banking industry. It will also provide the emerging RF banking industry with RF bankers who can show the real difference by the mode of service they offer and be able to explain it well. This will help us achieve our long-term objective of creating the foundation for a new banking service, RF banking, that is offered nationwide.
3. It offers consumers the choice between conventional riba-based banking services and RF banking products and services. The consumer will enjoy the ability to choose from a wide variety of banking, financing, and saving products and services.
4. It encourages the members of the faith-based communities that believe in a riba-free lifestyle, including the American Muslim community, to participate fully in the U.S. economic system, integrate with it, and become important contributors to American life without violating their religious beliefs. This will have a great social impact on the growing American Muslim community and faith-based communities at large, and will encourage savings and entrepreneurship.
5. It creates an atmosphere of healthy competition between the riba-based conventional banking products and services and the RF banking products and services. This competition should be beneficial to the consumer.

RIBA-BASED CONVENTIONAL FINANCING VERSUS RF FINANCING

To contrast the approach taken in a riba-based conventional financing with RF financing, let us consider a case study.

A family wants to buy a car for \$30,000. They only have \$6,000 of the purchase price. They approach a bank to help them finance the car. The following is a comparison between how the process would likely go in a riba-based banking setting as compared to RF banking setting.

Riba-based conventional banker:

1. Evaluates the application form.
2. Concludes that the family derives a good income and that they have a good balance sheet, and a good credit history. Also, the banker finds that the family's cash flow could help them pay for a larger car or even to take a bigger loan without putting the \$6,000 down. The reason is that the banker is interested in "selling" a larger loan to increase the profitability of the bank.
3. Decides to lend the family (i.e., rent them) money at a certain rate [interest rate] over a period of time. In fact, the banker may encourage the family—especially if they have a good credit history—to stretch the repayment period for a longer time. The repayment period defined by the banker can even be longer than necessary, because (the banker says) he or she wants to help improve the family's surplus cash flow. In fact, it also helps the bank derive more interest income from a good, qualified family as the loan repayment is extended.
4. The riba-based conventional banker may convince the family to buy a bigger and more equipped car. This is because the larger loan amount will only represent a small addition to the monthly payment, and it will be taken care of by prolonging the financing period (term of the loan).

RF (riba-free) banker:

1. Evaluates the application form.
2. Concludes that the family derives a good income and that they have a good balance sheet, good credit history, and good tax returns. Also, the banker finds that the family cash flow is enough to cover the monthly payment for the car purchase.
3. Calls around to ask car leasing agencies—such as Hertz and Enterprise, as well as manufacturers' leasing agencies, such as the Toyota, Ford, and GM fleet leasing divisions—about the utility value of the car measured by the lease rate charged in the market.

4. Draws up an agreement with the family that complies with the RF finance legal requirements.

In this agreement, the family acts as the agent of the RF bank to buy the car. The transaction is structured such that the family would own 6,000/30,000, or 20 percent, of the car, and the RF bank would (temporarily) own 80 percent of the car. The family agrees to buy the bank's share of the car for the same value, or $\$(30,000 - 6,000) = \$24,000$. This way, the bank does not own the asset (as based on Shari'aa) and is in compliance with the U.S. banking rules and regulations. The family, based on their cash flow, agrees to pay back the bank's share, interest-free over a period of (for example) three years, or \$8,000 per year. This is called the *Return on Capital (RonC)*. In lieu of the promise to pay back *RonC*, the family gives the RF bank a lien on the car. In lieu of the joint ownership of the right (perfected by the lien) to use the property, the family and the RF bank divide the income from the lease among themselves in the (changing) proportion of unpaid capital.

The family and the RF banker independently survey the market to find a fair leasing rate for a similar car in the same market. They negotiate a fair lease and agree to it. Here, the lease is divided between the family (20 percent in the beginning, rising to 100 percent over three years) and the bank (80 percent in the beginning and declining to 0 percent over a three-year term). This is called the *Return on Capital (RonC)* for the RF bank. The proprietary computer program developed by LARIBA is mechanically not much different from a regular amortization schedule. The difference is that the variable in the LARIBA program is the car lease rate defined by the market, while the *riba*-based amortization schedule uses interest rate—the rental rate of money—as an input parameter. In other words: In the *riba*-based conventional banking model, the unknown is the monthly payment. In the RF banking service, the monthly payment is calculated based on the lease rate using the declining equity model, and the unknown is the rate of return on investment.

The family and the RF banker, in order to satisfy the laws of the land, sign a promissory note that documents the repayment of the debt (*dayn*—no time value of money) and the declining lease rate in a total monthly payment. To comply with the laws of the land, the RF banker plugs in the monthly market measured and agreed-upon rent of the facility representing the lease rate, the purchase price, the down payment, and the number of years to pay back into the LARIBA proprietary computer program. The program calculates the rate of return on investment, which is called in the RF system “implied” interest rate. This rate is disclosed to the client to comply with the “truth-in-lending” Regulation Z.

Please note that the resulting “implied” interest rate is not uniformly the same. It differs from one car to another, based on the leasing rate the same car would bring in the relevant market. If the rate of return on investment is higher than the rate of return expected by the investors, the RF banker encourages the family to buy the car and would unilaterally reduce the monthly rental rate obtained from the market so that the monthly payment would compete with that offered by *riba*-based conventional banks. If the rate of return on investment was calculated to be much lower than that expected by investors, the RF banker would inform the family that buying this car is not a good investment, and the financing would be declined.

In the RF banking environment, the RF banker encourages the family to pay their car off as quickly as possible in order to reduce the burden of debt on the family’s cash flow and free more money to save for the future.

LOOKING FOR A SUITABLE BANK TO ACQUIRE

In 1989, we started searching for banks available for sale. We stumbled into a report called the *Findley Report*,¹ which is published by a prominent banking law firm in Southern California. The firm was started by a leading California attorney who specialized in helping communities obtain charters for community banks. The *Findley Report* is an amazing source of banks’ financial information and great reading material for me. We all pored over it and studied the financials and profitability of many banks.

In 1989, after feeling more comfortable that the concept of RF financing works and that there was demand for RF financing—and knowing that we were really hurting for more capital—we began to consider buying a small bank. We called for a meeting with Mr. Findley, Sr. He invited us to his rather humble office in the city of Yorba Linda (in Orange County, California) and sat us down. After the niceties of introducing ourselves and briefing each other on what we do, he looked us in the eyes and shocked us by saying, “There are three reasons that I know why someone would like to own a bank: The first is that he/she is stupid, the second is that he/she wants to put hands in the ‘cookie jar’ and taste from it—” (by this, he meant using the bank money for personal benefit) “—and the third is that they are genuinely interested in serving people in the community without expecting any rewards or recognition.” I was quiet for a few seconds and came back directly by saying that we belonged to the third group. We told him that our passion was to build a bank that will serve the community. He apparently believed us, and introduced us to his son, who was also an attorney in the same field—the honorable Gary Steven Findley, Esq. who runs the firm today. We became good friends and developed mutual trust and rapport.

Throughout my life, I can attest to the fact that when God wanted to help me achieve a goal, He would create an event that made a change in the scene or brought a certain person in my life to help me do so. When I started thinking of LARIBA, God created the reasons for me to meet the distinguished pioneer; Sheikh Saleh Abdullah Kamel, the founder of Dal-lah Al Baraka Group in Saudi Arabia. This man was then (when I met him in 1987)—and still is until today—one of the most influential, vi-sionary, and busy Islamic bankers in the world, and one of the most diffi-cult people to get an appointment with. He happened to be visiting Los Angeles in mid-1987 and attended a congregational prayer, which I was leading as an imam. He liked my ceremony, approached me after I fin-ished, and he said that he wanted to know me. He introduced himself. I had no idea who he was and what he did. He politely asked that we meet. I agreed—as I always do with people who approach me. Later, I asked about him and the person who briefed me did not believe that this influential Islamic banker had asked me for an appointment. We became very close family friends. Our mutual respect and appreciation for each other continues today. I learned a lot about the concepts of Islamic bank-ing and finance from him and from the many distinguished and highly accomplished and qualified scholars he was able to assemble from most of the Muslim world to get RF financing off to a good start in the Gulf, Europe, and the United States. As if God wanted to add to that gift to help us in our efforts to realize the vision of popularizing RF banking in America, God created the reasons for me to meet the father and son banking attorney team of Mr. Gerald Findley, Esq. and his son Mr. Gary Steven Findley, Esq.

When we started looking to buy a bank in America, we considered offering an RF finance window into a regular riba-based conventional bank. This idea was extremely controversial when it was first implemented in Malaysia. The issue of major concern was how one could justify, from the point of view of Shari'aa, owning a financial institution that dealt with the forbidden riba while at the same time claiming to be active in offering an RF banking window. In fact, many of the puritans and strict Muslims be-lieve that this is a clear case of hypocrisy that should never be allowed. This problem has been investigated at length by a number of jurists and scholars. It was first investigated in Malaysia and then in the Middle East.² However, after many conversations and “spot” opinion checks with leaders in the community, we decided to abandon the idea of opening an RF banking win-dow in a riba-based bank. The problem of dealing with riba-based (conven-tional) and RF financing models in the same institution troubled many of the Muslim scholars of Shari'aa and many members of the American Mus-lim community.

The U.S. banking system has emerged from a community-based banking network to become the most sophisticated banking system in the world.³ The system offers products and services that meet the traditional needs of the community. At the same time it is active in many other services, such as in developing new products that are technology based or focused on expanding the type and quality of financial services and products. While the U.S. banking system is primarily based upon tradition, to a certain extent this banking system has only recently recognized the financial and banking traditions of a significant segment of the American population—the American Muslim community. The faith-based communities of all faiths have been endowed with a reservoir of highly qualified professionals, entrepreneurs, business executives, successful scholars, and distinguished students. Most of the community members are compelled to violate one of the most basic requirements of their faith: dealing with interest, or *riba/ribit*. The Community Reinvestment Act (CRA), which played an important part in the American banking system in the 20th century, was originally introduced to allow community banks to gather community savings and reinvest these savings into the community and not outside it. CRA has helped many communities develop their housing, consumer, and business needs and has also helped in creating job opportunities for the members of the community.

MAKING HISTORY: ACQUIRING THE BANK OF WHITTIER, N.A.

To look for a bank, we sat down to list the characteristics of the bank we wanted to acquire in order to offer in it RF banking and finance services. The following is the list we came up with:

1. *Capital* required to buy the bank should not exceed \$1.5 to 3.0 million.
2. *Loan portfolio* should be very small so that it could be reviewed thoroughly by our team on a loan-by-loan basis.
3. *Type of charter* we preferred was a National Association (N.A.) Charter, which would enable us to serve other states in addition to California.
4. *Bank location* should be somewhere in the center between Los Angeles County and Orange County (in California).

It took us almost eight years to locate the Bank of Whittier as our target bank for purchase. During this long time, we would identify a bank, and then Gary Findley and our group would go to visit its president, to get a feel for the bank management's reaction to the idea of its being acquired, and to

take a closer look at the bank. Upon our return, we would assemble a team to evaluate our impression from the first meeting and to make a decision as to whether we should proceed. We looked at six banks in the period between 1990 to 1997.

At the end of 1996, we took another look at a bank we had considered earlier. The Bank of Whittier, NA was chartered in December 1982 and was owned by a holding company structure called the Greater Pacific Bancshares (the letters NA stand for National Association, which means that the bank is chartered by the U. S. Treasury Department's OCC—the Office of the Comptroller of the Currency).

In March 1997, Gary Findley and I went to meet the chairman of the Bank of Whittier at that time, Mr. N. Ghannam (87 years old at that time), who was a first-generation American of Lebanese descent. His father had immigrated to the United States after World War I. Mr. Ghannam was in the printing business. He told us that he owned a few shares of the bank, but the share price kept going down because the bank was not run well and the shareholders wanted out. He went on buying more and more shares in the bank. He had assembled a small board of directors to help him run the bank. As a result, at the time we met him, Mr. Ghannam owned about 55 percent of the shares. We had a number of meetings with him, and agreed that he would sell the bank. What he did not understand clearly was the meaning of the word “sell.” He thought that he would be selling his 55 percent share. We advised him that there are many rules and restrictions regarding his other shareholders, and that fiduciary responsibility required that he sell his other shareholders' shares before his. He impulsively said that meant all the bank's shares must be sold. We (some of the shareholders of LARIBA) agreed to buy the shares, and ended up owning almost 93 percent of the shares of the holding company.

The Bank of Whittier offered us the best opportunity to meet the strategic parameters we set for ourselves.

1. It was (and is) a national bank.
2. The bank was wholly owned by a holding company; Greater Pacific Bancshares. The holding company was (theoretically) traded on the stock market. Of course, at that time, it was traded as a *pink sheet* item. But, we reasoned, as we improved it, increased its capital, increased the number of shareholders, assigned it to a good market maker, and started introducing it to the investment banking community, it would be a good publicly traded stock in which to invest.
3. Its assets amounted to approximately \$29 million. In fact, it was one of the last few small, independent banks left in southern California that had not been acquired or merged.

4. Its capital was approximately \$2.3 million.
5. Its loan portfolio had been cleaned regularly during the bank and savings and loan crisis of the 1980s and early 1990s. In fact, the bank had stood the test of the 1980s banking crisis and was still in operation.
6. It is located in a city in the center between Los Angeles County and Orange County, which makes it accessible to many community members.
7. The bank's senior staff was essentially out because of their bad performance, but not all were replaced. This situation helped us to participate in the selection of the new management (while waiting for federal approval for change of bank control).

The Bank of Whittier had been in business since December 1982. It offered a unique service environment, with "sit-down" teller stations, and a location on Whittier Boulevard, a major commercial street, in the same complex with the Whittier Community Hospital and at least two medical doctors' professional buildings.

In December 1997, we signed an agreement with the Board of Directors of Greater Pacific Bancshares and Bank of Whittier to purchase up to 100% of the shares of Greater Pacific Bancshares. The Bank was operating under a Memorandum of Understanding (MOU) from the regulators. The MOU required that the management and board of directors improve the board of directors committees and supervision, hire necessary senior staff, increase capital, and not distribute dividends or acquire new companies/banks until approved by the authorities. After reviewing the OCC's most recent bank examination results, we concluded that it was good to note that the examiners were now increasingly positive about the bank because of its new management and the new loan cleanup and classification system installed by the new management. In addition, the feeling was that the MOU might be removed very shortly. The total of adversely classified items, as a percent of the total assets, was 6.6 percent. Out of that, total past-due and non-ac-cruel loans and leases were 5.8 percent of the total gross loans and leases. *ALLL*, allowances for loan and lease losses, were adequate and the analysis used was reasonable. The *ALLL* totaled approximately \$796,000 in mid-1997 and was 4.6 percent of the total loans.

In general, the new management continued its efforts to improve credit quality, credit administration, and risk management. Based on the public information and the audited financial statement of the bank and bank holding company, we came up with the following:

- *Capital ratios*: Tangible equity capital as a percent of total assets was estimated at 7.8 percent, indicating that the bank passed the

capitalization test and was considered well capitalized. However, more capital would be needed to strengthen the bank earnings by deploying new loans into the assets. It was recommended that at least \$1 million in fresh capital be injected immediately after takeover. However, a \$3 million capital increase (total capital of approx. \$5.3 million) would greatly improve the bank's earnings.

- *Earnings analysis:* Net income (after tax) was expected to be 0.64 percent of total average assets. ROAA (Return on Average Assets) was lower than it had been in 1996 (0.86 percent) due to the aggressive loan write-off by the management (in coordination with us while waiting for the approvals). Earnings analysis indicated that the bank had a strong *net interest margin* (NIM). But this NIM continued to be offset by weak assets quality and high overheads. The NIM was 6.95 percent, which compared favorably to peer banks. However, loan losses and deterioration in the Small Business Administration (SBA) and Business Manager (factoring) portfolios resulted in ALLL provisions of at least \$380,000 by the end of 1997. Despite this, the bank was expected to be able to earn at least \$165,000 in 1997. Overhead expenses, particularly consulting fees, had been very high historically. However, they declined 18 percent in the first 6 months of 1997 compared to the first 6 months of 1996, and were expected to decline further under the new management. Many unnecessary overhead expenses were curtailed or were on their way out; the SBA loans had been brought to a halt, and the Business Manager (factoring) had been canceled and the loan officer in charge removed. It was expected that monthly profitability would improve as a result of management's decision to increase loan volume, primarily through carefully selected loans (we expected these to be RF loans.)
- *Liquidity:* Bank liquidity was satisfactory, and liquidity risk was low. Short-term investments were 24 percent of total assets and included approximately \$4 million in Fed Funds sold and approximately \$2.4 million in CDs. The loan-to-deposit ratio was 67 percent. This indicated the need for new high-quality loans added to the portfolio. We thought that this was an excellent entry point for our LARIBA portfolios in Pasadena. The fund management and investment strategy needed to improve upon the bank's operating results by establishing a good investment portfolio in which to invest the bank's liquid assets without sacrificing risk and liquidity, while earning the highest return possible.
- *Interest rate risk:* The bank's interest rate risk position was good. The bank's balance sheet was asset sensitive, with rate-sensitive assets (RSA) of \$27.2 million, higher than its rate-sensitive liabilities (RSL) of

\$17.8 million within a one-year period. The RSA/RSL gap was 1.72 at 60 days and 1.33 at 1 year. The goal was to keep it at 1 to 1.5. A sensitivity analysis showed that with a 100-basis point decline in interest rates, annualized net interest income exposure was \$82,000.

We signed the preliminary agreement to be approved by the bank's board and shareholders. We obtained these approvals. We then set out to take a very close look at the details of the bank's operations, its assets, and in particular its loan portfolio. We evaluated the financial statements, the law suits (if any), the loan portfolio (loan by loan), and the operations of the bank. We discovered more about the MOU that the bank was operating under, and the details of the special restriction from the OCC as detailed in the MOU. One of the criticisms the OCC had was that the bank did not have a detailed set of operating policies; there were other criticisms about the bank's operations, its policies, and its profitability. Placing an MOU on a bank is not an action that can be undertaken lightly. The bank management is required to operate according to a plan approved by the OCC, and the bank management must go to the OCC for any decision. This slows down management operations and limits management flexibility, but it is the price that must be paid when a bank's management does not abide by the rules and regulations. This MOU was removed in the early 2000s after fulfilling the requirements of the OCC.

If the readers think that was the end and that we now owned a bank . . . please think again.

The next major and most demanding step was gaining the approval of the United States government's banking authorities for the buyers to assume control of the bank, a process called "change of control." In the case of the Bank of Whittier, government regulators were represented in three entities. These were:

1. *The Office of the Comptroller of the Currency*, because the OCC supervises National Banks. That is why we—as buyers of the shares who would become the control persons of the bank—had to file a full application with the OCC.
2. *The Federal Reserve Bank of San Francisco and the Federal Reserve Board (FRB)*, because the Bank of Whittier was owned by a Holding Financial Services company that was supervised by the FRB.
3. *The Federal Deposit Insurance Corporation (FDIC)*, because the bank was a member of the FDIC system.

The application process took a long time. The application forms to change control of the bank required full background information and

disclosures that might go back to the childhood of the applicants, their place of origin, their education, their financial details, their criminal records, and their business history, in detail. The application also called for a complete description of the reasons why the new control persons wanted to take control of the bank, how they would operate the bank, what their business plans were for the bank, and how they would serve and improve the bank's service to the community. The regulators also required that the new control group prepare a complete business plan for the bank's future budget and financial projections.

In an effort to reduce legal expenses and the pre-acquisition cost, our team first took the applications from Mr. Findley's office and then would spend very long nights completing them and preparing the plans and reports the application requested. In many cases, some of us were traveling out of the country and would operate via telephone and fax, because the Internet was not popular yet. We would send the completed forms and reports to Mr. Findley, who would edit them and pass them on to the regulators. The regulators would respond with more questions and inquiries for Mr. Findley, who would pass them on to us. We would again prepare the detailed answers to these questions. The word "detailed" here sometimes worked to our detriment because, as we learned from Mr. Findley's office, when we got a question from a government agency, that question had to be answered in a specific fashion, in full and clear details, and in a direct way, without opening new topics or subjects. Not abiding by these rules and course of action triggered more questions. The process took approximately one year of back-and-forth communications that culminated in a telephone meeting in January 1998 (during *Ramadan*) that was attended by:

- The OCC in California and in Washington, D.C.
- The Federal Reserve Bank in Washington, D.C. and the Federal Reserve Bank of San Francisco
- The FDIC in Washington, D.C.
- Mr. Gary Findley and his associate
- Our team

The government agents thanked us—the applicants—for “. . . your patience, perseverance, detailed answers, and your posture as humble professionals. . . .” We, in return, thanked them for their wonderful and refreshing due diligence. I wanted to lighten the atmosphere, so I told them that they now knew more about us than our parents and family ever had. This experience is shared here in great detail to reassure the reader of the quality of the U.S. banking system and the meticulous detail the system goes through to make sure that the regulations of the system are put in

effect. What happened in 2008 and before was due to a group of irresponsible people who violated the law, violated the trust placed in them, and ended up hurting all of us.

We thought that this was the end of our challenges and that we now had a bank. The local community paper published the news, and we all were delighted. Frankly, we were expecting the whole community to rush to transfer their accounts to the bank. Well, that did not happen! We also thought that we could run the bank in the same fashion we ran LARIBA, for the benefit of the whole community. We did not know what we were getting ourselves into. The community banking fraternity, we discovered, is an interesting group to say the least. Please enter the new domain called community banking. Many of the community banks were run by veterans who prided themselves in front of others—visitors, customers, other bankers, and auditors—as to how many years of “banking” experience they had. You heard them bragging about their “40 years of banking experience.” We ended up with a few of them. I developed an interesting sensitivity scale, in which I raised a big mental red flag whenever I heard that claim uttered. I once told one of them, who really did not have much to offer except that claim to fame, “Did you ever consider the possibility that you were making the same mistakes for 40 years but did not know about it?”

The reader may also find interesting a request made by one of the candidates for president of the bank. After stating his huge salary and benefits request, he asked for two SLX automobiles. Frankly, I did not know what he meant. I asked him why he needed two cars. He said that he wanted one for him and another for his wife. I obviously told him no! I then called my young daughter to ask her what an SLX car was. She said, “Dad, I thought you did not like expensive cars. An SLX is a Mercedes Benz that can cost \$120,000.” A story like this should give the reader an insight into the state of affair of a few bankers and how it changed compared to the community building and loan society banker we watched Jimmy Stewart portray in the movie *It’s A Wonderful Life*.

We tried to work with at least two bank presidents to convince them of the responsibility to reinvest in the community, to care for people, to go out and mix with the community, and to serve people. It was very difficult. We were not treated nicely, because we were looked at as outsiders to the community banking fraternity and as people who did not have “enough” banking experience. We also discovered that any time we shared some of the successes we had experienced at LARIBA, they would directly come back to tell us that it is not doable, because the regulators would not approve. We would come back and show them that other successful banks in the business were doing the same.

Around the year 2000, a bank president sent to the OCC a letter claiming that I was interfering in the management of the bank, which was in complete violation of the banking regulations because I worked at the time for another investment bank—Citigroup/Smith Barney. I committed in writing to the OCC that I would not step foot in the bank again. In fact, from that time until I took early retirement from Citigroup and started managing the bank, I did not set foot in the bank—as I promised—until our management came to run the bank.

It is also interesting to share with the reader what happened to us when we arrived at the Bank of Whittier on July 10, 2003 to take over bank management. Most staff had resigned and we were left with two employees. The bank's total assets were approximately \$26 million, and the bank had been losing money. We could not even find an insurance company that would agree to insure our executives and officers against any business mishaps. The bank was going from bad to worse. There were no written policies in any of the bank's operations, and the bank treasury and accounting systems were not well taken care of. There was no experienced operations manager, there were no manuals for the computer systems, the financial ledgers were not properly balanced by the person in charge, and customers had no respect for the new team. One day in our second week of running the bank, two contractors arrived at the bank to cash some checks, and we were very busy. One of them made a loud and noisy scene. I approached him politely to ask him to please lower his voice and to tell me what the problem was. He said, "In this country, American customers expect immediate service," and he proceeded to make some references to the fact that I am an immigrant. I smiled at him and asked him and his partner to step into my office. Then I closed the door and gave him a real piece of my mind. I told the man that I was proud to be a first-generation American—"but I want to assure you that in this great country, I started with nothing, I must have paid much more in taxes than he did, and that he should never demean or put people down again because of their accents or national origin". The man was shocked. His partner apologized and he followed. His partner is still the bank's customer to this day.

After arriving at the bank we decided to clean it up—to refurbish the bank facilities to give the feel of a private community bank with a "family living room" atmosphere. We also obtained board approval to improve the technology and systems so that we could have a fully automated banking operation that would be ready for the 21st century, in addition to a very user-friendly Web site (www.BankOfWhittier.com).

We started looking for associates who could help build up the bank. Another person who was also a gift from God was a young man I met by

mere coincidence in one of the community centers. Mike Abdelaaty was a banker with Bank of America at the time, where he had spent seven years of his career. He then moved to Sanwa Bank (now Bank of the West) for ten years, and he spent three years in the one of the Gulf oil-producing countries. While in Los Angeles, I always solicited his support in the banking and finance work that we did at LARIBA. After his return to the US in 1999, he contacted me and decided to join LARIBA as its president.

Another interesting experience we went through was dealing with the audit firm that audited the finances of the bank. We noticed the sloppiness of the representatives who came to collect the bank's information and documents. We went through with the audit in the first year, but were not satisfied; many of us were not comfortable with the results. It was felt that the certified public accountant (CPA) who signed our financial statements did not do his due diligence and did not know the financial condition of the bank. I shared this information with Gary Findley and the board and they authorized a change. We commissioned another CPA firm that we were very happy with and we are using the firm even now.

We started with a very small staff. We had to spend long and hard hours to put together a full set of policies by which the bank would operate. In addition, we started to look for outside auditors who could come and audit—on behalf of the Board of Directors—bank operations, bank compliance with government regulations, the bank loan portfolio, and *Bank Secrecy Act* matters. We went through our first-ever OCC examination as a new team and we received wonderful results. From this humble beginning, we have come a long way. The Bank of Whittier, NA was rated a five-star bank by Bauer Financial during the 2008 financial meltdown.

OPERATING THE FIRST RF BANK IN THE UNITED STATES

As explained in Chapter 2, in today's banking lingo, one can conceptually define *riba/ribit*-based financing as renting money for financing, secured and unsecured (non-collateralized credits that are not asset or service based). In RF banking, a bank's financing activity is conceptually looked upon as an investment by the bank in the individual (or the company) in order to help that entity acquire tangible and productive assets and/or services. In his capacity as an investor of the bank's money—which is the community's money—the RF bank credit officer makes sure that the financing facility is used for a specific purpose and that the investment is prudent and makes economic merit.

The time has come to publicize and popularize the new *RF banking* brand as a complementary community banking and financing service, to allow the community to make a choice. The free market system will be the judge of the real value of this RF finance and banking system to the average consumer in the United States.

Our Strategic Approach to Restructure the Bank of Whittier

On July 10, 2003, our team of three associates arrived at the Bank of Whittier to take over the management of the bank. We found that the bank was in a very sorry state of affairs. In addition, the OCC requested that we submit to them within a few weeks a detailed plan that documented how the new team would change the fortunes of the bank.

The Bank Restructuring and Workout Plan: Turning the Bank Around

To begin, the management team developed a number of goals that had to be achieved in order to turn the bank around and start operating it as an RF bank. The following is a list of these goals:

1. Rectify any regulatory concerns as soon as possible.
2. Increase the bank's capital.
3. Stress quality in services, and use a new slogan that identified our character as an RF bank: *We Do Not Rent Money—We Invest in Our Customers.*
4. Control bank expenses in a tight, micro, detailed way. For example, we used both sides of the copier paper and recycled paper in the copying machine to save on paper.
5. Hire highly educated and qualified staff.
6. Use the best banking and service technologies available.
7. Improve bank facilities to give a feel of a private bank and a living room ambience in order to attract new clients who would feel like members of our new and expanding bank family.
8. Achieve reasonable and competitive profitability, compared to bank peer group.
9. Increase loan (credit) portfolio to 70–75 percent of total deposits, and then increase deposits and loans in a parallel mode.
10. Improve quality of and expand the bank's loan portfolio using RF financing values and discipline.

11. Do not allow speculation lending.
12. Do not do business with intoxicant sellers, bars, check cashing, pawn shops, gambling casinos, or individuals deriving their income from socially irresponsible sources and activities.
13. Popularize the RF concepts that require that we do not “sell” or “buy” loans. We invest with the customer, and we do not sell our relationships. We service all the financing that we originate.
14. Be fair to all.
15. Be active in serving the community.
16. Offer new RF products and services to attract new deposits and customers.
17. Offer a Bank of Whittier Credit Card Service through a bank that specializes in credit card services, because the bank does not have the staff available to administer credit card services, and it cannot compete with the mega-bank issuers of credit cards. These conditions drastically reduce the credit risk exposure to the bank, while offering an important facility to our customers without the bank getting involved in any prohibited interest charging. The card is a Visa network card that offers credit, but the bank advises the customers to pay within a month to avoid paying *riba* (interest). This advice is posted in red letters on the front page of the bank’s Web site. We may be one of the few banks that strongly encourages its customers *not* to use credit cards as a means of borrowing. The other card is a regular Visa-linked *automatic teller machine* debit (ATM) card that only dispenses money or credit up to the deposits in the account. I know that some call the debit cards “*Islamic*” credit cards! We insist that we call it what it really is.

Specific Action Plan and Steps Taken by Bank Management

After a number of intensive brainstorming sessions attended by the new management and the board of directors the new management recommended (and the board of directors approved) the following list of actions:

1. *Continue to develop a sound corporate image and reputation in the local community, with the business community, and with the regulators.*
 - Better and professional facilities
 - Socially responsible, educated, experienced, friendly, humble, and professional staff
 - Deeper community involvement by communicating with civic associations, faith-based organizations, and surrounding universities

- Training bank staff on credit, business development, communications, appearance, and customer service at the newly innovated Bank of Whittier Open University
2. *Develop strong roots and community relations to increase the bank's client base and its loan (credit) and deposit activity.*
 - Call on existing bank holding company shareholders, friends, and our network of customers and potential customers to bring their business to the bank.
 - Call on medical doctors and professionals in our building and surrounding buildings, including Whittier Hospital, Presbyterian Hospital, and neighborhood fast food restaurant franchises.
 - Call all existing deposit and loan clients and bank shareholders.
 - Actively ask for referrals.
 - Hold in-person meetings with existing clients and prospects, in order to act as their trusted bankers.
 - Hire staff from the bank's immediate service areas and through neighboring colleges.
 - Participate actively in the Chamber of Commerce.
 - Develop personal working relationships with city and county elected officials.
 - Broaden and stress the offering of diversified RF banking services.
 - Cross-sell bank products and services.
 3. *Review all bank policies and develop new bank policies and train staff through bank open university.*
 - The following is an abbreviated list of policies developed by the new management team and reviewed and approved by the board of directors:
 - Employee Handbook
 - Credit Policy
 - USA PATRIOT Act Policy
 - Bank Secrecy Act Policy
 - Customer Identification Program, used to open new accounts
 - Anti-Money Laundering Prevention Policy
 - Large Currency Transactions and Kiting Detection Policy
 - Availability of Funds Policy for out of town and area checks
 - Audit Policy
 - Funds Management Policy
 - Liquidity Policy
 - Wire Transfer Policy
 - Investment Policy
 - Information Technology and Information Security Policy

- Emergency Preparedness Plan and Procedure
 - Disaster Recovery Plan
 - Policy and Procedure for Privacy (Gramm-Leach-Bliley Act)
 - Vendors' Management Policy
4. *Improve and enhance the security of the bank facilities, systems, and operations.*
- Equip the bank with the most up-to-date alarm and security systems.
 - Run drills and emergency tests for different scenarios, such as fire, earthquake, loss of power, loss of computer connection to the central computer processor, loss of server, and loss of Fed-Line Connection.
 - Continue to implement frequent risk-based outside audit programs in all bank operations, loans, consumer compliance, BSA activities, accounting and finance, and technology.
5. *Continue to improve bank quality of services and operating efficiency.*
- Assemble a strong team of RF bankers and instill a conservative, professional, helpful, and friendly operating culture.
 - Continue to hire highly educated, computer-literate, professionally sound team members.
 - Hire trainees from surrounding colleges to prepare candidates for future employment at the bank and to fulfill the bank's social responsibility of training future generations.
 - Train staff on systems and on high ethical, moral, and professional standards.
 - Streamline management by focusing on specific job functions and the measurement of staff achievements against the board of directors' approved budget, joint planning, goal setting, and comparing results with budget.
6. *Improve the computerization and automation of bank operations and services.*
- Start using a standard client and prospect management and communications maintenance system on all staff's computers, to keep track of customers, prospects, loan renewals, and reviews.
 - Improve the quality of the bank's computer network.
 - Improve the quality of the hardware used by staff.
7. *Increase bank deposit base.*
- Continue to improve facilities to increase efficiency and attract customers.
 - Continue to improve service quality.
 - Tap existing network of community members and friends to open new accounts and to add new loans.

- Diversify products and services without having too many products that would confuse customers, using the “Keep It Simple Stupid - KISS” approach.
 - Expand customer base through better involvement with family, including children and grandchildren, to keep an evergreen book of clients.
 - Expand customer base through asking for referrals.
 - Continue to carve and deepen a unique corporate image and culture and promote social responsibility in lending and services.
 - Continue to advocate, enhance, and implement a bank policy of cultural diversity among employees and bank customers.
8. *Continue to reduce bank operating expenses.*
- Control expenses on all fronts by paying attention using a micro-expense review approach.
 - Motivate and reward team members by using productivity-based and bank profitability-based salary and bonus review programs through a system tied to personal production and bank profitability.
 - Insist on thorough and prudent loan analysis to reduce loan losses.
 - Develop steps to achieve close scrutiny and follow up of existing loans in order to solve any problems and fix them, if possible, before they occur.
 - Conduct weekly comparisons between actual expenses and budgeted expenses.
9. *Increase bank income.*
- Actively pursue the prudent growth of the loan portfolio through deeper penetration of current depository customers and cultivation of new customers through referrals and community involvement.
 - Preserve and retain existing loans.

The following includes strategic steps that were implemented to improve the management process of bank operations.

1. *Open and review all incoming and outgoing mail and faxes.*

The first step taken by the new management was to find out where the bank was, and what was going on in its day-to-day operations. It is important that we share our management experience with the reader, because this was one of the important steps that helps in understanding what is going on in a newly acquired institution. The new chief executive officer asked that all incoming and outgoing mail and faxes be brought to his office so that he could open the incoming mail, review the incoming faxes, approve the outgoing faxes before they were sent, and read the outgoing mail before the envelopes were sealed, stamped,

and mailed. This is done always in the presence of another officer. The management needed to know how the bank was connected to the outside world by, for example, reviewing the incoming invoices and engagement contracts to know who we were dealing with. This step gave us—in three months' time—a great feel for the bank, its pulses, and its operations.

2. *Hire new employees*

We started looking for new employees to help. We needed at least two tellers, a highly qualified credit analyst, and a good accountant. We contacted some of the tellers and loan administration officers who had resigned from the bank, to see if they would come back. Only one teller accepted our offer; all the rest declined. In fact, some of them did not care to return our calls. We then started thinking about a way out of this dilemma. One of the management team came up with the idea of hiring business school students from the surrounding colleges and training them on the job. This proved to be a great idea. We appointed juniors at the business schools of the colleges and universities surrounding the bank as tellers and administration personnel. Later, these student workers became candidates for full-time positions as operations manager and supervisors. As to the training of these new employees, we started looking for a high-quality and experienced auditor of banking operations and compliance. We wanted an auditor who would critique and at the same time coach and train the new staff as he audited the bank. We asked him to come on a quarterly basis and to make himself available for consultation. We instructed all employees to be open to any comments or lack of compliance discovered by the auditor. We assembled them before the audit and asked them to look at the auditor as a teacher and a coach and to be truthful and open when answering any questions. The management team also had a meeting with the auditor and told him that the management and the board of directors wanted to learn in great detail what was wrong in the bank, not simply what was right. We also assured the auditor that we wanted to fix any problems he found as soon as they were recognized.

3. *Familiarize management and staff with computer systems and outside service providers*

Management also started to familiarize the staff with the computer operating system and with the bank check processing and technology providers in order to know how the business is conducted.

4. *Review all financial ledgers and financial operations*

On the financial front, the new management went through the bank financial statement and ledger in great detail with the chief

financial officer (CFO) and asked a lot of questions. This step was the most important, because we discovered many violations and non-posted transactions. For example, every time the CFO had not been able to balance the financial statement, he had assigned the discrepancy to a new bank control account. We discovered more than 30 such accounts. It took us many days and long hours to try to reconcile these accounts and we still were not able to reconcile all of them. That meant that we had to add such discrepancies to the bank losses.

5. *Evaluate the quality of the bank auditors*

After discovering the unfortunate state of affairs of the treasury function at the bank and the fact that the auditors/CPA of the bank never mentioned anything about it in their annual audited financial report, management was very disappointed in the quality and authenticity of the audits. We contacted the bank's CPA and complained about the unprofessional way the bank accounting and auditing system had been handled. He did not have the time, he said, because he was busy with bigger and more important banks. He relied on two young accountants who would come to the bank to pick up the statements from the CFO and leave. Management conferred with the board and the bank's lawyer. We had some concern about changing the bank auditor. We worried that people might suspect that the CPA auditor may have been in disagreement with bank management on some issues and that is why the bank was motivated to change the auditor. Management finally decided to push hard to change the auditing firm because we were sure of the sincerity of our motivations. It took us a long time to find an audit firm that would accept a bank that was losing money and had a new unproven management. I called Mr. Findley, and he found a firm that accepted the job. He kindly put in a very good word about the bank's new management. However, the new firm had a condition: they first wanted to review the bank's condition and then contact the existing audit firm. They did. After numerous contacts and interviews, they decided to become our auditors. We were all very impressed by the quality and depth of their work, and we felt comfortable about this most important bank activity.

6. *Develop the unique RF niche at the Bank of Whittier*

One of the most important steps in rescuing and restructuring the bank was to develop a strategic vision for a niche that would characterize that bank. The following sections give a summary of the process we used to articulate our RF finance system under difficult and challenging conditions.

Strategies Designed and Steps Implemented by the New Management

The following is a list of the strategies developed and the steps that management took to achieve our goal of restructuring the bank and operating it as a successful and preferred *riba*-free bank.

1. Determine the appropriate optimum size of deposits needed for the bank to serve its clients while reducing the cost of retaining expensive-to-keep deposits. In doing so, we reduced deposits and at the same time increased the loan portfolio to improve profitability and operating ratios. The strategy called for reducing the rates paid on all interest-bearing accounts first, and then, as the loan portfolio grew, we could grow the deposits accordingly. This strategy resulted in the closing of all those accounts that were interest-rate-sensitive liabilities. In a matter of a few months, asset size had decreased from \$29.2 million at December 31, 2003 to \$25.0 million at December 31, 2004, resulting in reduced interest expense.
2. Renovate the bank's facilities and automate its operations to improve the bank's image and operating efficiency.
3. Improve the bank's Web site and offer full Internet banking, bill pay service, and mobile phone banking, free of charge.
4. Prohibit board members from taking loans or benefiting directly or indirectly because of their position. In this way there would not be the slightest concern of violating Regulation O, which requires close procuring and disclosure of any insider activity in the bank operations.
5. Offer new Bank of Whittier products and services, like the FDIC-insured Certificate of Deposit accounts, which are insured up to \$50 million through a strategic alliance with the Certificate of Deposit Account Registry Service (CDARS).⁴
6. Employ highly qualified and educated employees with extensive banking experience, and train a new generation of bankers by hiring new business school graduates, preferably from the immediate neighborhood and the local universities around the city. In addition, hire tellers who are business school students. They are hired as part-time employees and cultivated to be future bank employees to meet our long-term growth plans.
7. Provide exceptional banking services by splitting the traditional bank "Loan Officer" function into two functions.
 - *RF Private Banker*—This function was designed to provide each customer with a well-trained and seasoned RF banker who is well-educated and becomes the point of contact between the client and

the bank. In addition, the RF private banker is responsible for knowing the family and its members, understanding their aspirations, and articulating their financial state of affairs. This allows the RF bank to integrate its services with the client's needs. The RF private banker aspires to add new family members to the RF Bank of Whittier's expanding family. The RF private banker is available to serve customers 24 hours a day, 7 days a week.

- *RF Credit Analyst*—The analysts hired are some of the better educated in the field of financial analysis; some have MBA degrees, and all hold business school degrees from some of the better business schools in the United States. The goal of the RF credit analyst is to conduct a thorough analysis of the financing application at hand and to develop a number of scenarios and recommendations for whether or not to finance the proposed financing using the RF discipline. We train our RF credit analysts not only to protect bank interests but also to be in the best interests of our customers. During the Open University training program, we drill the candidates and reiterate that the bank is not in the business of renting money. We are in the business of investing in our clients.
8. Provide all employees with the best training available through in-house training programs conducted by expert bank executives and senior managers, video training programs, Web-based programs, and live training presentations by outside experts. In addition, we train our employees on being socially responsible. Our simple focus is to train every one of our staff to be like George Bailey in *It's a Wonderful Life*. In fact, every employee is required to watch this movie at least twice a year, and it is discussed in bank training forums to improve the spirit of serving our clients. In addition, the bank finances special banking university MBA training programs at some of the best schools and universities in the nation.
 9. Expand bank services through a strategic alliance with a major bank. This alliance allows our business customers to access the services of the Bank of Whittier at any of the thousands of the major bank branches in the United States.
 10. Expand our business hours; we are open from 9:00 A.M. until 5:00 P.M. every weekday except on Friday when we close at 6:00 P.M. On Saturday we are open from 9:00 A.M. to 3:00 P.M.
 11. Develop policies for all aspects of bank operations, as well as a procedures and operations manual.
 12. Focus on improving the quality of the loan portfolio. Perhaps this is the most important aspect of the strategy. This was done by:

- Contacting our community members in our Community Reinvestment Act (CRA) assessment area, especially those who have been underserved.
 - Closing and declining renewal of loans that were below our conservative credit underwriting standards, and increasing the loan portfolio through cross-marketing the existing customers and our existing network of personal and business contacts.
 - Developing new loans using strict and conservative RF underwriting standards.
 - Activating RF mortgage financing to attract new customers and increase bank income. The bank pass-through mortgage business has been an important contributor to its income and turn around.
13. Offer integrated banking services on both the asset and liability sides of the customers' ledger. This is done through the services offered by the bank's private bankers and business development managers.

THE STAFF AND EMPLOYEE POLICY: STRATEGY USED TO BUILD UP AND TRAIN BANK STAFF

I felt fortunate but immensely challenged due to the staff situation when I arrived at the Bank on July 10, 2003. I essentially had to staff a new bank, which was good, but the challenge was where to begin, where to find the staff, and most importantly what to look for.

One approach anyone in my situation would do is to contact an employment agency or to put an advertisement in the business papers like the *Wall Street Journal*. However, that was not an option, because of the type of bankers that would apply. They would ask for very high salaries, which the bank could not afford, and in general they would not agree to join a bank that was losing money and was in the shape that Bank of Whittier was in at the time. The other approach, which I tried, was to contact friends in the banking industry to help recommend bankers. I interviewed a few of them. I felt that they wanted a job and a big salary, which they knew was too large for the bank to afford in its state of profitability.

I sat down in a quiet moment to think. I reasoned that I could continue to use the services of the chief financial officer (CFO), but with very close supervision and a lot of patience to accommodate his "energy sapping" remarks and attitude. I would also seek some of the wonderful hardworking associates at LARIBA. I asked my deputy at LARIBA and the secretary of the board to act as the chief credit officer on a part-time basis, because the loan portfolio was very small, and I started looking for a smart,

sophisticated, and highly analytical credit analyst. I reasoned that this person did not have to have any banking experience. I called a friend and he recommended a person who was a perfect fit. He had an undergraduate degree in aerospace engineering (which meant to me a very careful approach to analysis), an MBA, and was working on his Certified Financial Analyst certification. He had a very heavy accent, and you had to listen carefully to him to understand his English. I mention this to share with the reader the value of a person that can be uncovered regardless of the accent, the national origin, the faith, the skin color, or the gender.

In this regard I want to share with the readers two experiences. When I was training at Shearson American Express for a cold-calling financial consultant job (telephoning a person one has never met to get to know that person and to offer one's services based on the experience and the service) that required excellent communication skills and clear expression, a co-trainee approached me and said he wanted to give me advice. He said that because of my accent, I needed to apologize to the person I cold-called, telling him or her that if he/she did not understand my accent to ask me to repeat what I said. I looked at him for a minute and said to him that he must be crazy. He thought that he had offended me and started to apologize. I told him that he had not offended me, but that if I had a scar on my face, I was not going to apologize for having it to every person I met. There are things that people cannot do much to change, and that should never be an impediment to their acceptance. In fact, it is all in the mind of the person who has the accent. If he accepts it and tries to improve it, he will be successful. If she feels sorry for herself and feels she is failing because she is discriminated against, she will fail. The mind is like a fertile earth. If you sow rose seeds in it, you'll see roses; but if you sow the seeds of poison ivy, you will be harmed by that poison. In my case, I went on to become the top achiever in the training class, and eventually became a trainer in the Financial Advisory school at Shearson, where I specialized in training people on how to make a cold call.

Another experience I had was with a customer at the bank. A prominent lady in a prominent family in the city had an account with the bank. I knew that the bulk of her money was at another bank. Our private bankers at the bank and I personally tried very hard to encourage her to transfer her banking service to us, because she appeared on the NSF (non-sufficient funds) list every morning. I finally had a private meeting with her. I asked her to tell me frankly why she was not expanding her relationship with us. She said the first thing I needed to do was to hire employees who speak English without an accent. I thanked her for her feedback. She continued to be on the NSF list. At a meeting of the operations department, they all complained about the way she treated them when they called her respectfully to

tell her that she had written a check without sufficient funds to cover it. We all were surprised, because she never apologized but was always rude. We decided to ask her to close the account. During my exit interview, I told her that I was sorry about the “accent” problem, but asked her to remember that the United States was founded and built and still is being built and refreshed by people with accents, and I wished her the best.

The New Staff: A Strategy for Defining Whom to Look for and Where to Search

We also decided to home-grow our own RF bankers using two approaches. The first was to announce banking entry positions in the business schools in surrounding universities. We looked for fresh graduates with an excellent scholastic achievement, with a grade point average (GPA) of at least 3.75. We also advertised for part-time tellers in the business schools. The idea was to train these tellers at a young age (sometimes as young as 18) and watch their progress closely in order to recruit our future staff. I knew that this strategy and approach would need time, but I reasoned that this would be the best investment for the future.

To train all of these new and fresh bankers, we pioneered the “Bank of Whittier Open University.” The classes are held at least twice a year for 45 days from 8:00 A.M. to 9:30 A.M. and all staff members, including those with prior banking experience, are required to attend. The training program will be discussed in detail in Chapter 12.

This proved to be the most important decision we ever made to change the fortunes of the bank. These smart fresh graduates were like sponges, hungry to absorb information, to learn new banking regulations and techniques, and to create new solutions to the problems we faced. They brought with them vibrancy, fresh ideas, challenges that made me feel younger, and most importantly the ability to be molded to believe in, operate, and serve people in our new brand of banking—the RF banking way.

THE AUDIT POLICY: STRATEGY USED FOR AUDITING BANK FUNCTIONS AND OPERATIONS

At the Bank of Whittier, N.A., we pioneered the use of a risk-based audit program that helped management establish which areas of bank operations needed to be audited in light of the risks associated and the extent of those risks. Management innovated and developed a computer-based program that helped institutionalize this risk-based audit function and determine the frequency of each audit area.

All board members, management, and staff of the bank sincerely believe that the various internal and external audits and the onsite examination are a process of discovery, cleansing, training, and coaching of bank management and staff that will help to improve the quality and effectiveness of bank operations. Bank management trains bank staff to listen carefully, to not argue, to not act defensively, and to learn. They are also trained to take prompt and immediate action to correct any oversight or error pointed out by the auditors. The management asks bank auditors to point out specifically what needs to be fixed so that we can attain the highest level of compliance.

The board of directors' *audit committee* is responsible for establishing and maintaining an effective audit function that satisfies statutory, regulatory, and supervisory requirements.

As stipulated by the standards of government regulators, directors cannot delegate these responsibilities. However, they may delegate the design, implementation, and monitoring of specific internal controls to management and the testing and assessment of internal controls to auditors and other outside vendors. The board of directors' meeting minutes should reflect decisions regarding audits, such as external audit engagement terms (including any decision to forgo an external audit), the scope of audits to be performed, or why an audit of a particular area is not necessary.

Members of the bank's board of directors are specifically responsible for:

- Reviewing and approving audit strategies, policies, programs, and organizational structure
- Monitoring the effectiveness of the audit function

Following are the audit functions to be executed by the board's *audit committee*:

- Facilitation of the appointment and work of the internal and outside auditors
- Analysis and evaluation of their findings
- Recommendation of corrective actions with a specific timeline
- Reporting of all findings and recommendations in the Board's meeting minutes
- Review of financial content of the bank's financial reports to be submitted to stockholders, the public, and/or regulatory agencies
- Recommendation and/or initiation of an investigation of adverse operation results or trends, where applicable

The formality and extent of a bank's internal and external audit programs depend on the bank's size, complexity, scope of activities, and

risk profile. The board of directors must carefully consider how extensive the audit program must be to effectively test and monitor internal controls and ensure the reliability of the bank's financial statements and reporting.

The board of directors must strive to ensure that the bank's audit system is efficiently capable to test internal controls in order to be able to identify:

- Inaccurate, incomplete, or unauthorized transactions
- Deficiencies in the safeguarding of bank assets
- Unreliable financial and/or regulatory reporting
- Violations of laws and/or regulations
- Deviations from the bank's policies and procedures

The board of directors is expected to do its best to be aware of all risks and control issues for the bank's operations, including risks in new products, emerging technologies, information systems, and Internet banking. Control issues and risks associated with increasing reliance on technology include:

- Increased user access to information systems
- Reduced segregation of duties
- Potential unidentifiable errors resulting from the shift of operations from paper to electronic audit trails
- Lack of standards and controls for end-user systems
- Increased complexity of contingency plans and information system recovery plans

Engagement Letter for External Auditors

In its efforts to prudently identify the most capable auditing entities for its various audits, the bank's board of directors must invite and request external auditors to submit engagement letters before commencing audit work. Such a letter will be expected to reflect preliminary discussions between the bank's board and/or senior management and the external auditor(s).

The engagement letter(s) will stipulate, among other things, the audit's purpose, its scope, the period to be covered, and the reports the auditor will develop. Schedules or appendixes may accompany the letter to provide the board with more details of the proposed audit. The letter may briefly describe procedures to be used in specific areas. If the scope of the audit is limited in any way, the letter may specify procedures that the auditor will omit. Additionally, the letter would specify if the auditor were expected to

render an opinion on the bank's financial statements and/or other bank functions, depending on the type of audit being conducted.

Types and Scope of Various Audits

I. *Risk Assessments and Risk-Based Auditing*

Risk assessment is defined as the means by which the board of directors identifies and evaluates the quantity of the bank's risks and the quality of its controls. An effective risk-based auditing program will cover all of the bank's activities. The frequency and depth of each area's audit will vary according to the area's risk assessment. All areas of bank activities are included in order to establish the frequency of the audit necessary to mitigate any risk in bank safety and soundness and its reputation.

II. *External Audit Function*

The primary role of the external auditor is to independently and objectively review, evaluate, and document its findings about bank activities in order to help the board of directors of the bank and its management maintain and/or improve the efficiency and effectiveness of the bank's risk management, internal controls, and corporate governance.

External auditors must understand the bank's strategic direction, objectives, products, services, operating philosophy, strategy, and processes. The auditors will communicate their findings to the board of directors and to senior management.

III. *Objectives*

The objectives of external audits are:

- a. To provide reasonable testing, review, and analysis of the Bank's operations to ensure the effectiveness of internal controls over financial reporting, the accuracy and timeliness in recording transactions, and the accuracy and completeness of financial and regulatory reports
- b. To perform an independent and objective view of the bank's activities, including processes relative to financial reporting and bank operations
- c. To determine whether the bank complies with laws and regulations and adheres to established bank policies and whether management is taking appropriate steps to address control deficiencies

IV. *Types of Audits*

The type of audit commonly referred to as a Directors' Examination entails specified and/or agreed-upon procedural reviews of the adequacy of internal controls and accuracy of financial information. The independent audit parties can be public accountants, certified internal auditors, certified information systems auditors, bank management

firms, bank consulting firms and/or other parties knowledgeable in banking.

Please note that the frequency of the audits suggested below is determined in light of the risk-based audit discussed earlier.

1. *Financial Statement Audit* by a certified public accounting firm, CPA

An independent audit of financial statements should be designed to ensure that the bank's financial reports are prepared in accordance with Generally Accepted Accounting Principles (GAAP) and that the Independent Financial Statements are performed in accordance with Generally Accepted Audit Standards (GAAS). The scope of the audit will be sufficient to enable the CPA to express an opinion on the bank's financial statements.

The following list represents areas for which the board of directors requires an annual audit.

- a. Cash and due from banks
- b. Loans
- c. Allowance for loan and lease losses (ALLL)
- d. Premises and equipment
- e. Other assets and liabilities
- f. Deposits
- g. Notes payable
- h. Non-interest income
- i. Expenses
- j. Equity (holding company, if applicable)
- k. Tax return

2. *Operational, USA PATRIOT Act, Bank Secrecy Act (BSA), and Office of Foreign Assets Control (OFAC) Audits*

These types of audits include a review of policies, procedures, and operational controls to determine whether risk management, internal controls, and internal processes are adequate and efficient. Operational audits generally include procedures to test the integrity of accounts, regulatory reports, and other aspects of operations. These audits may also include a review of management and employee compliance with bank policies and procedures. The Operational, Bank Secrecy Act, and OFAC audits should be scheduled annually at specific times.

3. *Compliance Audit*

This type of audit determines whether the bank is complying with bank procedures and internal and external regulatory regulations. This audit should be scheduled annually—or as frequently as the risk analysis may call for—preferably in the first quarter of the year but no later than the second quarter of the year. It focuses on

the bank's adherence to consumers' compliance regulations to ensure that the bank has adequate systems and control procedures to avoid any violations.

4. *Loan Review Audit*

This type of audit is conducted to assess the quality of the bank's loan portfolio and provide an early alert of problem loans or negative portfolio patterns or trends, as well as the adequacy of and procedure used to calculate allowance for loan and lease losses (ALLL). The ALLL estimation process at the Bank of Whittier is conducted, as discussed earlier, by following a unique risk-based method and a proprietary computer program pioneered by the bank to include in the calculation all risk factors that may have an impact on the various credit facilities. The process will be detailed in Chapter 12.

5. *Information Systems, Technology, and Security Audits*

These types of audits assess the controls over the bank's electronic data processing and computer-related areas. These audits focus on management, development, support and delivery, data security, and physical security. Information system and technology audits also include a review of computer and client services systems, end-user reports, electronic funds transfers, and service provider activities. This type of audit should test the system and should be completed annually in the first quarter of the year. It also helps review and critique security systems used by the bank.

V. *Treasury, Financial, Operations, and Loans Management Monthly Certifications*

The responsibilities of the operations and loans departments are to certify all general ledger accounts as provided by management to the application—DDA, savings, time deposits, and loans. For example: operations staff will be responsible for certifying all loan systems to the general ledger, and the loans department staff will certify all operations applications to the general ledger. The certifications will be completed according to the certification listing and provided to the CFO monthly before the tenth day of every month.

Audit Response by Management

Management will prepare a written response to the board of directors within 21 days from the date of the submission of the particular audit report and its findings. The management response will outline any deficiencies or

concerns outlined by the audit, list the corrective actions already taken, and identify specific recommendations, plans, and the expected time of completion for responding to such recommendations to fix the problems discovered by the audits.

The management response will be sent to the firm that completed the audit. In addition, the OCC (usually during the exam time) and other related regulatory bodies, if needed, will be notified by the bank's chairman of the board of directors as to the different audit findings, the corrective actions already taken, and the actions that will be taken, including expected time of completion.

NOTES

1. The founder of the Findley Company was Mr. Gerald Lee Elmer Findley who, from 1952 to his retirement in the late 1980s, was responsible for chartering more than 120 banks in California. Gerald and his son Gary have organized almost 200 banks in their 50 years of business.
2. The Central Bank of Malaysia (Bank Negara Malaysia) sought the views of three jurists on the permissibility of establishing a RF Banking window as an additional but unique service offered by a conventional RIBA bank. The Shari'aa scholars involved were the late (Almarhoum) Tan Sri Professor Ahmad Ibrahim and Professor Dr. Mahmoud Saedon Awang Uthman from the International Islamic University, Malaysia, and Tuan Haji Mohammad Shahir Ahmad from the Department of Islamic Affairs in the Malaysian Prime Minister's Office. These scholars' view was that "a conventional riba-based bank, whose operations are conducted on the basis of interest, *is not prohibited* from operating an RF banking window." The conclusion was based on foundation of Shari'aa. Many jurists and scholars around the world have concluded that owning and operating a conventional riba-based bank that offers RF banking products and services, such as lease-to-purchase financing, is not only acceptable but is encouraged (Dr. Saleh Malaikah, in a private communication dated May 17, 1999; the opinion is based on research conducted by Dr. Malaikah). Scholars like Dr. Al-Qari, and Dr. Abdul-Rahman Serri have concurred with this opinion. This, however, does not make riba-based finance activities permissible according to Shari'aa. The ownership and operation of a conventional bank by Muslims is desirable and encouraged if the intention is to offer riba-free products as a unique service that can compete with the conventional banking products. The gradual approach with a clear plan will allow riba-free banking products and services to be tested by the consumers who will ultimately make the final decision about which products and services they like to use.

3. Yahia Abdul-Rahman, Mike Abdelaaty, and Gary S. Findley, Esq., *The Challenges of Offering a LARIBA Products and Services Window in an American Bank*, presented at the Harvard University Seminar on Islamic Banking, 1999.
4. CDARS stands for “Certificate of Deposit Account Registry Service,” which offers CD investments insured up to \$50 million by capitalizing on the network of member banks accepting tranches of the deposit and swapping it with a deposit from that bank in the originating bank. This allows the originating bank to access the FDIC coverage of the corresponding bank.