

Village Bank & Trust Financial Corp.  
Form 10-K  
March 22, 2007

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-KSB**

**ANNUAL REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2006**

**TRANSITION REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 0-50765**

**VILLAGE BANK AND TRUST FINANCIAL CORP.**

(Name of small business issuer in its charter)

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**16-1694602**  
(I.R.S. Employer  
Identification No.)

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**1231 Alverser Drive, P.O. Box 330, Midlothian, Virginia**  
(Address of principal executive offices)

**23113**  
(Zip Code)

Issuer's telephone number **804-897-3900**

**Securities registered under Section 12(b) of the Exchange Act:**

None

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Stock, \$4.00 par value	The Nasdaq Stock Market

**Securities registered under Section 12(g) of the Exchange Act:**

None

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

State issuer's revenues for its most recent fiscal year. \$21,502,000.

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The aggregate market value of common stock held by non-affiliates of the registrant as of March 19, 2007 was approximately \$39,969,000.

The number of shares of common stock outstanding as of March 19, 2007 was 2,562,088.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be used in conjunction with the 2007 Annual Meeting of Shareholders are incorporated by reference into Part III of this Form 10-KSB.

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**Village Bank and Trust Financial Corp.**

**Form 10-KSB**

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**PART I**

**ITEM 1 DESCRIPTION OF BUSINESS**

**General**

Village Bank and Trust Financial Corp. (the **Company**) was organized under the laws of the Commonwealth of Virginia as a bank holding company whose activities consist of investment in its wholly-owned subsidiary, Village Bank (the **Bank**). The Bank opened to the public on December 13, 1999 as a traditional community bank offering deposit and loan services to individuals and businesses in the Richmond, Virginia metropolitan area. During 2003, the Company acquired or formed three wholly owned subsidiaries of the Bank, Village Bank Mortgage Corporation ( **Village Bank Mortgage** ), a full service mortgage banking company, Village Insurance Agency, Inc. ( **Village Insurance** ), a full service property and casualty insurance agency, and Village Financial Services Corporation ( **Village Financial Services** ), a financial services company.

The Company is the holding company of and successor to the Bank. Effective April 30, 2004, the Company acquired all of the outstanding stock of the Bank in a statutory share exchange transaction. In the transaction, the shares of the Bank's common stock were exchanged for shares of the Company's common stock, par value \$4.00 per share ( **Common Stock** ), on a one-for-one basis. As a result, the Bank became a wholly owned subsidiary of the Company, the Company became the holding company for the Bank and the shareholders of the Bank became shareholders of the Company. All references to the Company in this annual report for dates or periods prior to April 30, 2004 are references to the Bank.

We offer a wide range of banking and related financial services, including checking, savings, certificates of deposit and other depository services, and commercial, real estate and consumer loans. We are a community-oriented and locally managed financial institution focusing on providing a high level of responsive and personalized services to our customers, delivered in the context of a strong direct relationship with our customers. We conduct our operations from our main office/corporate headquarters location in which we have an operating branch, and we have eight additional branch offices.

The Company was incorporated in January 2003.

**Business Strategy**

Our strategies include the following:

*To be a full service financial services provider enabling us to establish and maintain relationships with our customers.*

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*To attract customers by providing the breadth of products offered by larger banks while maintaining the quick response and personal service of a community bank. We will continue to look for opportunities to expand our products and services. In our first seven years of operation, we have established a diverse product line, including commercial, mortgage and consumer loans as well as a full array of deposit products and services.*

*To increase net income and return to shareholders through continued loan growth, while controlling the cost of our deposits and noninterest expenses.*

*To expand our branch network to lower our cost of funds and diversify our loan portfolio with retail, consumer and commercial loans.* We believe that branching will help us attract customers of financial institutions that have consolidated in our region who desire the personal services of a community bank. We plan to open two new branches in 2007, further expanding our presence in Chesterfield and Henrico Counties. Our ability to open new branches, however, may be affected by such things as availability of building materials, weather conditions, site approval by local government and regulatory approval.

*To expand our capacity to generate noninterest income through the sale of mortgage loans.* In 2005, we opened a new loan production office in Henrico County which we believe will expand our ability to originate mortgage loans for sale.

*To continue to emphasize commercial banking products and services.* Small-business commercial customers are a source of prime-based loans, fee income from cash management services, and low cost deposits, which we need to fund our growth. We have been able to build a commercial business base because our staff of commercial bankers seeks opportunities to network within the local business community. Significant additional growth in this banking area will depend on expanding our lending staff.

*To target larger commercial customers.* In 2006, we increased our capital by approximately \$7.2 million through the exercise of common stock warrants issued in 2002. This increase in capital increased our legal lending limit to approximately \$4,000,000. Increasing our legal lending limit will help us accommodate the borrowing needs of larger customers.

Our officers, employees and the directors live and work in our market area. We believe that the existing and future banking market in our community represents an opportunity for locally owned and locally managed community banks. In view of the continuing trend in the financial services industry toward consolidation into larger, sometimes impersonal, statewide, regional and national institutions, the market exists for the personal and customized financial services that an independent, locally owned bank with local decision making can offer. With the flexibility of our smaller size and through an emphasis on relationship banking, including personal attention and service, we can be more responsive to the individual needs of our customers than our larger competitors. As a community oriented and locally managed institution, we make most of our loans in our community and can tailor our services to meet the banking and financial needs of our customers who live and do business in our market.

We provide customers with high quality, responsive and technologically advanced banking services. These services include loans that are priced on a deposit-based relationship, easy access to our decision makers, and quick and innovative action necessary to meet a customer's banking needs.

## **Location and Market Area**

We have focused our operations in Chesterfield County, Virginia, which, despite its potential for business development and population growth, has been underserved by community banks. Chesterfield's resources are very favorable for businesses seeking a profitable and stable environment. The county offers superb commercial and industrial sites, an educated work force, well-designed and developed infrastructure and a competitive tax structure. Chesterfield has been awarded the U.S. Senate Gold Medallion for Productivity and Quality. The county has the highest bond rating from three rating agencies - Standard and Poors, Moody's and Fitch.

Our strategy is to build a strong community banking franchise and branch network in Chesterfield and then expand our franchise into other counties in the Richmond Metropolitan area. In Henrico County, we opened a loan production office in 2005 and a retail branch in 2006. We have also expanded our community network in 2006 by opening a retail branch in Powhatan County. In 2007,





we have plans to open two more branches, one in Chesterfield County and one in Henrico County. Chesterfield, Henrico and Powhatan Counties have each seen strong population growth in recent years, and the growth trends are expected to continue. According to the U.S. Census Bureau, the 2000 population of Chesterfield County was 259,903, compared to 209,274 in 1990. The number of households in Chesterfield County climbed from 73,441 in 1990 to 93,772 in 2000. The projected figures for 2010 are a population of 319,000 in 117,500 households. The 2000 population of Henrico County was 262,300 compared to 217,849 in 1990. The number of households in 2000 was 108,121 compared to 89,138 in 1990. The projected figures for Henrico County for 2010 are a population of 291,000 in 122,900 households. These population figures place Henrico and Chesterfield, respectively, as the largest two counties in central Virginia and the third and fourth largest counties in the state.

Residential growth in Chesterfield, Henrico and Powhatan Counties remains strong. For the four quarters ended September 30, 2006, Chesterfield County issued 5,564 permits for new single-family homes, Henrico County issued 4,313 and Powhatan County issued 874. Unemployment percentages for Chesterfield, Henrico and Powhatan for the third quarter of 2006 were 2.8%, 3.0% and 2.8%, respectively, well below the national average of 4.7%. Developers continue to locate their planned communities in western Chesterfield County. The Winterpock area of Chesterfield County is expected to see substantial growth over the next six years, with the Deer Run development nearing completion and subdivisions such as Birkdale, Ashbrook, and Bayhill Point continuing their impressive growth. The primary road serving these growing subdivisions is Route 360, and all of these communities are within two miles of our Clover Hill branch. Henrico County has long been a strong bedroom community to Richmond. Many of the metropolitan Richmond area's older upscale housing communities call Henrico home and the western part of Henrico has seen substantial growth in both new business as well as residential communities. The western section of Route 288, the circumferential highway around the Richmond Metropolitan area, was completed in 2004 and significantly improved access to and from Chesterfield County and Henrico County by the surrounding counties.

At December 31, 2006, we had nine full service banking offices (including one in our main office), which were staffed by 38 full-time employees. Our senior staff averages more than 25 years of professional or banking experience. Our principal office, which houses our executive officers and loan department, was opened in November 2003 and is located at 1231 Alverser Drive, Midlothian, Virginia 23113. One of our branch facilities is located in this building. Our main telephone number is (804) 897-3900. Six of our branch offices are located in Chesterfield County, with one branch office each in Henrico and Powhatan Counties. Each branch office has been strategically located to be convenient to business and retail customers in the growth sectors of Chesterfield County. In addition to our branch locations, we opened a loan production office in Henrico County in 2005.

We have plans to open two more branches in 2007 with emphasis in the Henrico market and expanding into Mechanicsville, Virginia. The opening of any additional banking offices will require prior regulatory approval, which takes into account a number of factors, including, among others, a determination that we have capital in an amount deemed sufficient to warrant additional expansion and a finding that the public interest will be served.

Prominent local newspapers, one regional newspaper, and a number of radio and television stations provide diverse media outlets. The broad exposure of television, print media and radio offers several opportunities to explore effective advertising and public relations avenues for the Company.

### **Banking Services**

We receive deposits, make consumer and commercial loans, and provide other services customarily offered by a commercial banking institution, such as business and personal checking and savings accounts, drive-up windows, and 24-hour automated teller machines. We have not applied for permission to establish a trust department and offer trust services. We are not a member of the Federal Reserve System. Our deposits are insured under the Federal Deposit Insurance Act to the



limits provided thereunder.

We offer a full range of short-to-medium term commercial and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements) and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education and personal investments. We also originate fixed and variable rate mortgage loans and real estate construction and acquisition loans. Fixed rate residential loans are usually sold in the secondary mortgage market.

Our lending activities are subject to a variety of lending limits imposed by federal and state law. While differing limits apply in certain circumstances based on the type of loan or the nature of the borrower (including the borrower's relationship to the bank), in general, for loans that are not secured by readily marketable or other permissible collateral, we are subject to a loans-to-one borrower limit of an amount equal to 15% of our capital and surplus. We may voluntarily choose to impose a policy limit on loans to a single borrower that is less than the legal lending limit. We are a member of the Community Bankers' Bank and may participate out portions of loans when loan amounts exceed our legal lending limits or internal lending policies.

### **Lending Activities**

Our primary focus is on making loans to small businesses and consumers in our local market area. In addition, we also provide a wide range of real estate finance services. Our primary lending activities are principally directed to our market area.

*Loan Portfolio.* The net loan portfolio was \$238,498,000 at December 31, 2006, which compares to \$170,447,000 at December 31, 2005. The Company has enjoyed strong loan growth the last two years reflecting the strong economy in the market we serve. Loans grew by 27% in 2005 and by 40% in 2006. Our loan customers are generally located in the Richmond metropolitan area. We do not have any subprime loans in our loan portfolio.

*Commercial Business Lending.* Our commercial business lending consists of lines of credit, revolving credit facilities, term loans, equipment loans, stand-by letters of credit and unsecured loans. Commercial loans are written for any business purpose including the financing of plant and equipment, carrying accounts receivable, general working capital, contract administration and acquisition activities. Our client base is diverse, and we do not have a concentration of loans in any specific industry segment. Commercial business loans are generally secured by accounts receivable, equipment, inventory and other collateral such as marketable securities, cash value of life insurance, and time deposits. Commercial business loans have a higher degree of risk than residential mortgage loans, but have higher yields. To manage these risks, we generally obtain appropriate collateral and personal guarantees from the borrower's principal owners and monitor the financial condition of business borrowers. The availability of funds for the repayment of commercial business loans may substantially depend on the success of the business itself. Further, the collateral for commercial business loans may depreciate over time and cannot be appraised with as much precision as residential real estate. All commercial loans we make have recourse under the terms of a promissory note. At December 31, 2006, commercial loans totaled \$17,889,000, or 7.4% of the total loan portfolio.

*Commercial Real Estate Lending.* We finance commercial real estate for our clients and commercial real estate loans represent the largest segment of our loan portfolio. This segment of our loan portfolio has been the largest segment since 2004 due to the significant real estate opportunities in our market area. We generally will finance owner-occupied commercial real estate at an 80% loan-to-value ratio or less. In many cases our loan-to-value ratio is less than 80%, which provides us with a higher level of collateral security. Our underwriting policies and

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procedures focus on the borrower's ability to repay the loan as well as assessment of the underlying real estate. Risks inherent in managing a commercial real estate loan portfolio relate to sudden or gradual drops in property values as well as changes in the economic climate. We attempt to mitigate those risks by

carefully underwriting loans of this type as well as following appropriate loan-to-value standards. Commercial real estate loans (generally owner occupied) at December 31, 2006 were \$100,039,000, or 41.4% of the total loan portfolio.

*Real Estate Construction Lending.* This segment of our loan portfolio is predominately residential in nature and comprised of loans with short duration, meaning maturities of twelve months or less. Residential houses under construction and the underlying land for which the loan was obtained secure the construction loans. Construction lending entails significant risks compared with residential mortgage lending. These risks involve larger loan balances concentrated with single borrowers with funds advanced upon the security of the land and home under construction, which is estimated prior to the completion of the home. Thus it is more difficult to evaluate accurately the total loan funds required to complete a project and related loan-to-value ratios. To mitigate these risks we generally limit loan amounts to 80% of appraised values on pre-sold homes and 75% on speculative homes, and obtain first lien positions on the property taken as security. Additionally, we offer real estate construction financing to individuals who have demonstrated the ability to obtain a permanent loan. At December 31, 2006, construction loans total \$80,324,000, or 33.3% of the total loan portfolio.

*Residential Mortgage Lending.* We make permanent residential mortgage loans for inclusion in the loan portfolio. We seek to retain in our portfolio variable rate loans secured by one-to-four-family residences. However, the majority of permanent residential loans are made by the Bank's subsidiary, Village Bank Mortgage, which sells them to investors in the secondary mortgage market on a pre-sold basis. Given the low fixed rate residential loan market in recent years, this allows us to offer this service to our customers without retaining a significant low rate residential loan portfolio which would be detrimental to earnings as interest rates increase. We originate both conforming and non-conforming single-family loans.

Before we make a loan we evaluate both the borrower's ability to make principal and interest payments and the value of the property that will secure the loan. We make first mortgage loans in amounts up to 95% of the appraised value of the underlying real estate. We retain some second mortgage loans secured by property in our market area, as long as the loan-to-value ratio combined with the first mortgage does not exceed 90%. For conventional loans in excess of 80% loan-to-value, private mortgage insurance is required.

Our current one-to-four-family residential adjustable rate mortgage loans have interest rates that adjust every 1, 3 and 5 years, generally in accordance with the rates on comparable U.S. Treasury bills. Our adjustable rate mortgage loans generally limit interest rate increases to 2% each rate adjustment period and have an established ceiling rate at the time the loans are made of up to 6% over the original interest rate. There are risks resulting from increased costs to a borrower as a result of the periodic repricing mechanisms of these loans. Despite the benefits of adjustable rate mortgage loans to our asset/liability management, they pose additional risks, primarily because as interest rates rise, the underlying payments by the borrowers rise, increasing the potential for default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. At December 31, 2006, \$36,408,000, or 15.1% of our loan portfolio, consisted of residential mortgage loans.

*Consumer Installment Lending.* We offer various types of secured and unsecured consumer loans. We make consumer loans primarily for personal, family or household purposes as a convenience to our customer base since these loans are not the primary focus of our lending activities. Our general guideline is that a consumer's total debt service should not exceed 40% of the consumer's gross income. Our underwriting standards for consumer loans include making a determination of the applicant's payment history on other debts and an assessment of his or her ability to meet existing obligations and payments on the proposed loan. The stability of an applicant's monthly income may be determined by verification of gross monthly income from primary employment and additionally from any verifiable secondary income. Consumer loans totaled \$6,730,000 at December 31, 2006, which was 2.8% of the total loan portfolio.



*Loan Commitments and Contingent Liabilities.* In the normal course of business, the Company makes various commitments and incurs certain contingent liabilities which are disclosed in the footnotes of our annual financial statements, including commitments to extend credit. At December 31, 2006, undisbursed credit lines, standby letters of credit and commitments to extend credit totaled \$97,579,000.

*Credit Policies and Administration.* We have adopted a comprehensive lending policy, which includes stringent underwriting standards for all types of loans. Our lending staff follows pricing guidelines established periodically by our management team. In an effort to manage risk, all credit decisions in excess of the officers' lending authority must be approved prior to funding by a management loan committee and/or a board of directors-level loan committee. Any loans above \$2,000,000 require full board of directors' approval. Management believes that it employs experienced lending officers, secures appropriate collateral and carefully monitors the financial conditions of our borrowers and the concentration of such loans in the portfolio.

In addition to the normal repayment risks, all loans in our portfolio are subject to the state of the economy and the related effects on the borrower and/or the real estate market. Generally, longer-term loans have periodic interest rate adjustments and/or call provisions. Our senior management monitors the loan portfolio closely to ensure that past due loans are minimized and that potential problem loans are swiftly dealt with. In addition to the internal business processes employed in the credit administration area, the Company utilizes its internal audit firm to review the loan portfolio. A detailed annual review is performed, with an interim update occurring at least once a year. Results of the report are used to validate our internal loan ratings and to provide independent commentary on specific loans and loan administration activities.

*Lending Limit.* As of December 31, 2006, our legal lending limit for loans to one borrower was approximately \$4,000,000. As part of our risk management strategy, we attempt to participate a portion of our larger loans to other financial institutions. This allows us to maintain customer relationships yet reduce credit exposure and stay within our legal lending limit.

## **Investments and Funding**

We balance our liquidity needs based on loan and deposit growth via the investment portfolio, purchased federal funds, and Federal Home Loan Bank advances. It is our goal to provide adequate liquidity to support our loan growth. Should we have excess liquidity, investments are used to generate positive earnings. In the event deposit growth does not fully support our loan growth, a combination of investment sales, federal funds and Federal Home Loan Bank advances will be used to augment our funding position.

Our investment portfolio is actively monitored and is classified as available for sale. Under such a classification, investment instruments may be sold as deemed appropriate by management. On a monthly basis, the investment portfolio is marked to market via equity as required by SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Additionally, we use the investment portfolio to balance our asset and liability position. We will invest in fixed rate or floating rate instruments as necessary to reduce our interest rate risk exposure.

For securities classified as available-for-sale securities, we will evaluate whether a decline in fair value below the amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security is written down to fair value as a new cost basis and the amount of the write-down is included in earnings. There were no securities at December 31, 2006 where a decline in market value was considered other than temporary.

**Competition**

We encounter strong competition from other local commercial banks, savings and loan associations,



credit unions, mortgage banking firms, consumer finance companies, securities brokerage firms, insurance companies, money market mutual funds and other financial institutions. A number of these competitors are well-established. Competition for loans is keen, and pricing is important. Most of our competitors have substantially greater resources and higher lending limits than ours and offer certain services, such as extensive and established branch networks and trust services, which we do not provide at the present time. Deposit competition also is strong, and we may have to pay higher interest rates to attract deposits. Nationwide banking institutions and their branches have increased competition in our markets, and federal legislation adopted in 1999 allows non-banking companies, such as insurance and investment firms, to establish or acquire banks.

The greater Richmond metropolitan market has experienced several significant mergers or acquisitions involving all four regional banks formerly headquartered in central Virginia over the past fifteen years. Additionally, other larger banks from outside Virginia have acquired local banks. We believe that the Company can capitalize on the recent merger activity and attract customers from those who are dissatisfied with the recently acquired banks.

At June 30, 2006, the latest date such information is available from the FDIC, the Bank's deposit market share in Chesterfield County was 6.39%.

#### **Effect of Adverse Economic Conditions**

Our business may be adversely affected by periods of economic slowdown or recession which may be accompanied by decreased demand for consumer credit and declining real estate values. Any material decline in real estate values could have a significant adverse effect on the operations of the Company as 89.8% of our loan portfolio is collateralized by real estate. Declines in real estate values can reduce projected cash flows from commercial properties and the ability of borrowers to use home equity to support borrowings and increase the loan-to-value ratios of loans previously made by us, thereby weakening collateral coverage and increasing the possibility of a loss in the event of default. In addition, delinquencies, foreclosures and losses generally increase during economic slowdowns or recessions.

We anticipate the majority of our depositors will be located in and doing business in the local market and we will lend a substantial portion of our capital and deposits to individuals and businesses in this market area. Any factors adversely affecting the economy of this market could, in turn, adversely affect our performance.

#### **Regulation**

We are subject to regulations of certain federal and state agencies and receive periodic examinations by those regulatory authorities. As a consequence of the extensive regulation of commercial banking activities, our business is susceptible to being affected by state and federal legislation and regulations.

**General.** The discussion below is only a summary of the principal laws and regulations that comprise the regulatory framework applicable to us. The descriptions of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, do not purport to be complete and are qualified in their entirety by reference to applicable laws and regulations. In recent years, regulatory compliance by financial institutions such as ours has placed a significant burden on us both in costs and employee time commitment.

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**Bank Holding Company.** The Company is a bank holding company under the Federal Bank Holding Company Act of 1956, as amended, and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board ) and Virginia State Corporation Commission ( SCC ). As a bank holding company, the Company is required to furnish to the Federal Reserve Board an annual report of its operations at the end of each fiscal year and to furnish such additional information as the Federal Reserve Board may require pursuant to the

Bank Holding Company Act. The Federal Reserve Board, FDIC and SCC also may conduct examinations of the Company and/or its subsidiary bank.

The Gramm-Leach-Bliley Act of 1999 (the Act) draws new lines between the types of activities that are financial in nature and permitted for banking organizations, and those activities that are commercial in nature and not permitted. The Act imposes Community Reinvestment requirements on financial service organizations that seek to qualify for the expanded powers to engage in broader financial activities and affiliations with financial companies that are permitted.

The Act allows a financial holding company to own banks, insurance companies and securities firms. A financial holding company is authorized to engage in any activity that is financial in nature, incidental to an activity that is financial in nature, or is a complimentary activity. These activities may include insurance, securities transactions, and traditional banking activities. The Act establishes a consultative and cooperative procedure between the Federal Reserve and the Secretary of the Treasury for purposes of determination as to the scope of activities permitted by the Act.

A bank holding company must satisfy special criteria to qualify for the expanded powers authorized by the Act, including the maintenance of a well-capitalized and well-managed status for all affiliate banks and a satisfactory community reinvestment rating.

**Bank Regulation.** As a Virginia state-chartered bank that is not a member of the Federal Reserve System, the Bank is subject to regulation, supervision and examination by the SCC's Bureau of Financial Institutions (BFI). The Bank is also subject to regulation, supervision and examination by the FDIC. Federal law also governs the activities in which we may engage, the investments we may make and the aggregate amount of loans that may be granted to one borrower. Various consumer and compliance laws and regulations also affect our operations. Earnings are affected by general economic conditions, management policies and the legislative and governmental actions of various regulatory authorities, including those referred to above. The following description summarizes some of the laws to which we are subject. The BFI and the FDIC will conduct regular examinations, reviewing such matters as the adequacy of loan loss reserves, quality of loans and investments, management practices, compliance with laws, and other aspects of their operations. In addition to these regular examinations, we must furnish the FDIC with periodic reports containing a full and accurate statement of our affairs. Supervision, regulation and examination of banks by these agencies are intended primarily for the protection of depositors rather than shareholders.

**Insurance of Accounts, Assessments and Regulation by the FDIC.** Our deposits are insured by the FDIC up to the limits set forth under applicable law, currently \$100,000. Deposits are subject to the deposit insurance assessments of the Bank Insurance Fund (BIF) of the FDIC. The FDIC is authorized to prohibit any BIF-insured institution from engaging in any activity that the FDIC determines by regulation or order to pose a serious threat to the respective insurance fund. Also, the FDIC may initiate enforcement actions against banks, after first giving the institution's primary regulatory authority an opportunity to take such action. The FDIC may terminate the deposit insurance of any depository institution if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed in writing by the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance if the institution has no tangible capital. If deposit insurance is terminated, the deposits at the institution at the time of termination, less subsequent withdrawals, shall continue to be insured for a period from six months to two years, as determined by the FDIC. We are aware of no existing circumstances that could result in termination of our deposit insurance.

**Capital.** The FDIC has issued risk-based and leverage capital guidelines applicable to banking organizations they supervise. Under the risk-based capital requirements, we are generally required to maintain a minimum ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit), of 8%. At least half of the total capital is to be composed of common equity, retained earnings and qualifying perpetual preferred stock, less certain



intangibles ( Tier 1 capital ). The remainder may consist of certain subordinated debt, certain hybrid capital instruments and other qualifying preferred stock and a limited amount of the loan loss allowance ( Tier 2 capital and, together with Tier 1 capital, total capital ). In addition, each of the Federal bank regulatory agencies has established minimum leverage capital ratio requirements for banking organizations. These requirements provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets equal to 4% for banks and bank holding companies that meet certain specified criteria. All other banks and bank holding companies will generally be required to maintain a leverage ratio of at least 100 to 200 basis points above the stated minimum. The risk-based capital standards of the FDIC explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a bank's capital adequacy.

**Other Safety and Soundness Regulations.** There are a number of obligations and restrictions imposed on depository institutions by federal law and regulatory policy that are designed to reduce potential loss exposure to the depositors of such depository institutions and to the FDIC insurance funds in the event the depository institution becomes in danger of default or is in default. The Federal banking agencies also have broad powers under current Federal law to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized, as defined by the law. Federal regulatory authorities also have broad enforcement powers over us, including the power to impose fines and other civil and criminal penalties, and to appoint a receiver in order to conserve the assets of any such institution for the benefit of depositors and other creditors. Village Bank continues to be classified as a well-capitalized financial institution.

**Loans-to-One Borrower.** Under applicable laws and regulations the amount of loans and extensions of credit which may be extended by a bank to any one borrower, including related entities, generally may not exceed 15% of the unimpaired capital and unimpaired surplus of the institution. Loans in an amount equal to an additional 10% of unimpaired capital and unimpaired surplus also may be made to a borrower if the loans are fully secured by readily marketable securities. An institution's unimpaired capital and unimpaired surplus includes, among other things, the amount of its core capital and supplementary capital included in its total capital under Federal regulations.

**Community Reinvestment.** The requirements of the Community Reinvestment Act ( CRA ) are applicable to the Company. The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution's efforts in meeting community credit needs currently are evaluated as part of the examination process pursuant to 12 assessment factors. These factors also are considered in evaluating mergers, acquisitions and applications to open a branch or facility.

**Economic and Monetary Policies.** Our operations are affected not only by general economic conditions, but also by the economic and monetary policies of various regulatory authorities. In particular, the Federal Reserve regulates money, credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

## **Employees**

As of December 31, 2006, the Company and its subsidiaries had a total of 109 full-time employees and 11 part-time employees. None of the Company's employees are covered by a collective bargaining agreement. The Company considers its relations with its employees to be good.

## **Dependence on Key Personnel**

Our growth and development to date have been largely dependent upon the services of Thomas W. Winfree, President and Chief Executive Officer, Jack M. Robeson, Senior Vice President/Lending, Raymond E. Sanders, Senior Vice President and Chief Operations Officer, Dennis J. Falk, Senior Vice President/Lending and Administration and C. Harril Whitehurst, Jr., Senior Vice President and Chief Financial Officer. The loss of the services for Messrs. Winfree, Robeson, Sanders or Whitehurst for any reason could have a material adverse effect on the Company.

## **Control by Certain Shareholders**

The Company has one shareholder who owns 6.50% of its outstanding Common Stock. As a group, the Board of Directors and the Company's Executive Officers control 20.63% of the outstanding Common Stock of the Company as of February 1, 2007. Accordingly, such persons, if they were to act in concert, would not have majority control of the Bank and would not have the ability to approve certain fundamental corporate transactions or the election of the Board of Directors.

**ITEM 2 DESCRIPTION OF PROPERTY**

Our executive and administrative offices are located at 1231 Alverser Drive, Midlothian, Virginia. We opened this office in November 2003. This office also houses our loan department and one of our retail branches. The two-story 8,000 square foot building, which has been substantially renovated, is owned by the bank. The cost of this building, including renovations, amounted to \$1,046,000.

Our largest deposit branch office is located at 13531 Midlothian Turnpike, Midlothian, Virginia. This was our initial office location and also housed our executive and administrative offices until the opening of the operations center on Alverser Drive. The building, which has been substantially renovated, is a two-story brick structure with a basement, consisting of approximately 3,500 square feet. It has five teller stations, three drive-up lanes and a drive-up ATM and night depository. Prior to December 31, 2002, this building was leased. It was purchased from our landlord on December 31, 2002 for \$1,713,000.

We have a branch office at 6736 Southshore Drive at Route 360 (Hull Street Road), in Chesterfield County. The building is a one-story brick structure consisting of approximately 2,400 square feet. The branch location was purchased in June 2002 for \$1,384,000. It has four teller stations, two drive-up lanes and a drive-up ATM and night depository.

We opened a third branch location at 4221 West Hundred Road, Chester, Virginia in April 2003. The building is a one-story brick structure with a basement consisting of approximately 1,800 square feet. The branch is being leased for a term of five years commencing April 1, 2003 and ending March 31, 2008 for total lease payments of approximately \$186,000 over the life of the lease. We have renewal options for two five year periods subsequent to the initial term. It has four teller stations, one drive-up lane and a drive-up ATM and night depository.

We opened our fourth branch at 13521 Waterford Place, in Chesterfield County, in October 2004 utilizing a mobile manufactured building which we purchased in April 2004 for \$46,000. The permanent branch building, a one-story brick structure consisting of approximately 2,400 square feet, was completed in June 2005 and cost \$646,000. It has three teller stations, two drive-up lanes and a drive-up ATM and night depository.

Our fifth branch, located at 6551 Centralia Road, in Chesterfield County, was opened in November 2005. The building is a one-story brick structure consisting of approximately 2,900 square feet. The branch is being leased for a term of eight years commencing November 19, 2005 and ending November 30, 2013 for total lease payments of approximately \$672,000 over the life of the lease. It has five teller stations, two drive-up lanes and a drive-up ATM and night depository.

In March 2006 we opened our sixth office at 11450 Robious Road, in Chesterfield County. We initially opened this branch with our mobile manufactured building and subsequently constructed a 2,400 square foot building that cost \$1,035,000 and is owned by the Bank. This branch has three teller stations, two drive-up lanes, and a drive-up ATM and night depository.

Our seventh office, located at 1650 Willow Lawn Drive, in Henrico County, was opened in May 2006. This is our first retail branch location outside Chesterfield County. The building is a three story brick structure. We lease the first floor consisting of approximately 3,000 square feet. The term of the lease is nine years commencing March 1, 2006 and ending February 28, 2016 with total lease payments of \$842,000 over the life of the lease. It has four teller stations, three drive thru lanes, a drive-up ATM and night depository.

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Our eighth office located at 1793 South Creek One was opened in December 2006 in Powhatan County. This is our first branch located in Powhatan County. This 2,400 square foot structure cost \$672,000 and has three teller stations, two drive-up lanes, a drive-up ATM and night depository.



Our properties are maintained in good operating condition and are suitable and adequate for our operational needs.

**ITEM 3 LEGAL PROCEEDINGS**

In the course of its operations, the Company may become a party to legal proceedings. There are no material pending legal proceedings to which the Company is a party or of which the property of the Company is subject.

**ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this report.

**PART II****ITEM 5 MARKET FOR COMMON EQUITY****AND RELATED STOCKHOLDER MATTERS****Market Price of and Cash Dividends on the Company's Common Equity**

Shares of the Company's Common Stock trade on the Nasdaq Capital Market (formerly known as the Nasdaq SmallCap Market) under the symbol VBFC. The high and low trade prices of shares of the Company's Common Stock for the periods indicated were as follows:

	High	Low
<b>2005</b>		
1st quarter	\$ 11.99	\$ 11.00
2nd quarter	14.04	11.09
3rd quarter	13.00	12.50
4th quarter	13.75	12.75
<b>2006</b>		
1st quarter	\$ 14.35	\$ 12.50
2nd quarter	14.25	12.50
3rd quarter	14.75	13.00
4th quarter	14.55	13.55

At March 19, 2007, there were approximately 985 holders of record of Common Stock.

The Company has not paid any dividends on its Common Stock. We intend to retain all of our earnings to finance the Company's operations and we do not anticipate paying cash dividends for the foreseeable future. Any decision made by the Board of Directors to declare dividends in the future will depend on the Company's future earnings, capital requirements, financial condition and other factors deemed relevant by the Board. Banking regulations limit the amount of cash dividends that may be paid without prior approval of the Bank's regulatory agencies. Such dividends are limited to the lesser of the Bank's retained earnings or the net income of the previous two years combined with the current year net income.

The Company did not repurchase any of its Common Stock during the fourth quarter of 2006.



**ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION**

**Forward-looking statements**

Certain information contained in this discussion may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are generally identified by phrases such as we expect, we believe or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

interest rate fluctuations;

risk inherent in making loans such as repayment risks and fluctuating collateral values;

economic conditions in the Richmond metropolitan area;