# THE VIRGINIA STATE BANKER

**Regulatory News for Virginia State-chartered Banks**
**State Corporation Commission - Bureau of Financial Institutions**
**Commissioner E.J. Face, Jr.**
**ISSUE NO. 6 ——— SPRING/SUMMER 1999**

## IN THIS ISSUE



The Virginia State Banker is published quarterly by the Virginia Bureau of Financial Institutions to provide useful information to the banks and savings institutions that it regulates, and any of their related interests. Reader comments and suggestions are welcome and should be addressed to:

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**Thanks to the following persons for their help in producing this issue of The Virginia State Banker:**
**Commissioner Face, Nick Kyrus, John Crockett, Ricky McCormick, Jane Owen, and Joyce Tinsley.**

# BANKING IN THE 21$^{ST}$ CENTURY

Banking, as we know it, was reinvented in this century. The decades of the 1900s brought the Federal Reserve, a single currency, and deposit insurance. The influence of computers has been tremendous, but other predictions have not materialized. Remember the phrase "paperless society"?

What's ahead for the next hundred years? Some technologies have emerged. Here are a few that all financial intermediaries may need to consider to remain competitive.

**Biometrics**

Biometrics is a method of identifying people based on their unique physical characteristics. Methods include fingerprint scanning, iris scanning, retina scanning, handwriting analysis, handprint recognition, and voice recognition. A Texas bank recently became the first bank in the country to use iris recognition at its ATMs.

Users enroll in a biometric authentication program by having their eyes, faces, signatures, or voices scanned. Key features from the scan are extracted, converted to unique templates, and stored as encrypted data. When the user needs access, the user's features are matched to the template to provide authentication. A match permits access.

Obstacles to wide acceptance of biometrics include expensive technology and privacy concerns. Individuals who think nothing of an ATM pin number may balk at the idea of having a body part scanned.

**Check Truncation**

Predictions of the demise of the check appear greatly exaggerated. Recent data indicate check volume continues to increase by more than one billion per year. Over 60 billion checks are written annually, and 10 billion are written at the retail point-of-sale. The estimated cost to handle a check (by merchant and bank) is $3.50. Check processing is labor intensive, and the check has to be moved many times in the process. What if the check could be "truncated" at the source?

**(continued on page 4)**

# VIRGINIA AND TENNESSEE BANK DEPARTMENTS REACH ACCORD

Tennessee Commissioner of Financial Institutions Bill C. Houston and Virginia Commissioner E. J. Face, Jr. have agreed, in an exchange of correspondence, that the interstate bank branching laws of their two states are similar enough to allow banks in one state to acquire one or more branches in the other. As interpreted by the two departments, the laws providing for branch acquisitions across the Tennessee-Virginia border are on substantially the same terms, the Commissioners decided.

After Congress passed the Riegle-Neal Interstate Banking and Branching Act of 1994, Virginia "opted in" the next year on a reciprocal basis to all kinds of interstate expansion, including acquisitions of bank branches. Tennessee did not follow suit right away, choosing to allow only interstate mergers and consolidations of banks until last year. Then, effective in May of 1998, the legislature authorized banks outside Tennessee to acquire the assets and assume the liabilities of any Tennessee bank branch, provided the branch had been in operation for at least five years. Tennessee law also permits an out-of-state bank, when such an acquisition is made, to establish or acquire additional Tennessee branches.

**RECENT BUREAU NEWS:**
Commissioner Face has been elected as an At-Large Director to The 1999-2000 Board of Directors of the Conference of State Bank Supervisors

The Tennessee Department of Financial Institutions then ruled that an out-of-state bank could make an initial acquisition of a number of Tennessee branches, so long as one of the branches (designated as the first being

(Continued on page 5)

## BRANCH APPLICATION FEES REDUCED BY SCC

Effective July 1, 1999, Section 6.1-39.3 of the Code of Virginia no longer requires banks to demonstrate that establishment of a branch or the relocation of an existing branch will be in the public interest. The amended section provides for processing of branch and relocation applications within 30 days, or 60 days in the case of an extended review period. The Bureau may deny a branch or relocation application if it finds that a proposal would have a detrimental effect on the applicant bank's safety or soundness, or that it is otherwise not in the public interest.

As a result of the amendment, the Commission and the Bureau have streamlined the application procedures and reduced the application fees by 50%. Effective July 1, 1999, the branch application fee is $900 and the relocation fee is $500. The new "trimmed" application forms may be obtained from the Bureau of Financial Institutions (Tel: 804-371-9690) or from the Bureau's web site at **www.state.va.us/scc/division/banking**.

## INTERSTATE TRUST OFFICES

The Multistate Trust Institutions Act (Article 3.3 , Chapter 2, Title 6.1 of the Virginia Code) went into effect on July 1, 1999. It provides for the establishment of interstate trust offices on a reciprocal basis. Virginia banks or trust companies wishing to establish trust offices outside of Virginia must apply to and receive permission from the State Corporation Commission.

Before approving an application for a trust office, the Commission must find (a) that the applicant has the financial resources sufficient to undertake the proposed expansion without adversely affecting its soundness and (b) that the laws of the host state permit the establishment of the trust office. In acting on the application, the Commission is required to consider the views of the state supervisors of the host state. Application forms for permission to establish a trust office outside of Virginia may be obtained from the Bureau of Financial Institutions (Tel: 804-371-9690) or from the Bureau's web site at **www.state.va.us/scc/division/banking**.

# BUREAU PROFILE

- **Name**: Robert W. Hughes (Bob)
- **Current Position and Years of Service**: Principal Financial Analyst; 19 years
- **Main Responsibilities**: Supervise and participate in examinations of depository institutions chartered by the Bureau of Financial Institutions.
- **Education and Professional Designations**:
  1977 Graduated Virginia Tech
  1997 Graduate School of Banking, LSU
  Certified Internal Auditor
  Certified Financial Services Auditor
- **Family**: Two children—daughter, 8 years old and son, 5 years old
- **Personal Interests**: Flying and golf

After having early aspirations to become a United States Air Force pilot because he loved to fly, Bureau examiner Bob Hughes ended up becoming responsible for examining some of the high-flying financial institutions that have called Virginia home. Bob, a Richmond native and Virginia Tech graduate, earned his pilot's license at the tender age of 19 and seemed well on the way to his dream job. However, the reduction of the United States armed forces at the end of the Vietnam war eventually sidetracked his goal to become an Air Force pilot.

Bob recently had a notable experience when he flew to London, England (on a commercial aircraft – unfortunately!!), along with fellow Bureau Principal Examiner Martin Holbrook, to conduct an examination of the Capital One branch operation that is located in that country. During the return flight, Bob and Martin were allowed to visit the Captain of the British Airways 747 in the cockpit while the plane was over Halifax, Nova Scotia!

While overseas, Bob was surprised to learn that one of the major differences in credit card transactions between the USA and Great Britain is that only about 40 percent of credit card sales are electronically authorized at the point-of-sale versus 96 percent in this country. He stated that during the examination, the team also conducted a site visit at the Capital One operations center which is located in Nottingham, England. Bob found the operations center to be very similar to the Capital One operations center located on West Broad Street in Richmond, Virginia.

When he's not examining depository institutions, Bob spends his time with his two children, golfing, and caring for three acres of yard. He doesn't have the opportunity to fly as much as he once did (his most interesting flight was to the world-renowned Oshkosh Air Show in Wisconsin in 1989), but he still keeps his interest in flying up to date.

# AN OUNCE OF PREVENTION . . .

Here we go again on everyone's favorite subject. We would, however, rather hear several (or a bunch) of you tell us this is old hat than to hear one say "I wish you had said something about that." If part of your preparation for Y2K does not include learning how to access the Fed Discount Window, or updating your current information with the Fed, we encourage you to do so. Most of you will likely be able to use your correspondent banks as usual, but we are talking about an unusual situation. If push comes to shove, and unanticipated problems should arise, would it not be better to know what to do than to be wondering?

The person to talk to at the Federal Reserve Bank of Richmond is Becky Snider. She can be reached at (804) 697-8450. The Federal Reserve Bank of Chicago has a section on its web site that has lots of information about the discount window. You can access it at www.chi.frb.org/loans/loans.html and read to your heart's content.

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# Banking in the 21st Century (continued)

Electronic check truncation is the conversion of a check at the point-of-sale into a debit transaction that is processed through the automated clearinghouse network. Here's how it works.

√ A customer presents a paper check at the point-of-sale.
√ The check is scanned through a check reader, and the pertinent information is captured.
√ The check is verified against a database.
√ The check writer signs an authorization permitting the paper item to be converted into an electronic truncation, and the check is stamped and returned to the customer. The transaction data is electronically transferred.
√ The customer's account is debited and the merchant's account is credited.

**Electronic Bill Presentment**

The automatic drafting of customer accounts for recurring transactions has been around for many years. One example is the automatic payment of a mortgage from a checking account. However, large bill issuers (such as telephone companies, utilities, and credit card companies) have begun to explore the efficiencies and savings associated with electronic bill presentment—delivering invoices and accepting payments electronically.

Large financial services companies have begun to form alliances for electronic bill presentment and the resulting cash management business. A recent study found that online consumers prefer to receive bills from their banks' websites rather than from internet service providers or others.

**Summary**

The challenges of the financial services business will likely continue to increase. Many of these will be driven by advances in technology, and changes in the desires of customers for new services and options. And as computer and internet accessibility comes to the masses, banks must be prepared to deliver more services through this medium. Home banking and internet banking will surely mature as banking options early in the new century. Financial service companies must keep an eye on the ever-changing landscape to ensure viability.

# Y2K CASH REQUIREMENTS

We're coming down to the planning wire on Y2K, and confidently feel the financial services industry is (or will be) ready. Customer reaction, especially as the year progresses and the day approaches, is unknown and difficult to gauge.

Communication with financial institution customers remains key in minimizing consumer worry about Y2K. Chances are, however, that some customers will want additional cash at year's end. Even the prudent among the Year 2000 prognosticators are recommending getting enough cash for the first week or so of the new year.

An essential component of Year 2000 planning includes provisions for liquidity and cash availability. Each institution should undertake an analysis of its potential liquidity requirements and sources of liquidity. The following list of issues should be considered when making cash contingency plans for your institution:

Analyze your customer base to estimate the demand for extra cash the bank may have to carry to meet the Y2K demand.

Make plans to obtain extra currency well in advance so that possible increases in customer demand can be met.

Review vault capacity, insurance limits, and bond requirements to ensure that you can handle additional cash holdings.

Review distribution and shipping requirements, and coordinate Y2K plans with your cash service provider and armored carrier.

Prepare to monitor and fill ATMs more frequently.

This list is not all-inclusive, and additional cash and liquidity considerations may need to be addressed.

# THREE NEW BANKS AUTHORIZED

The State Corporation Commission recently approved three new banks in Virginia. They are **Towne Bank** in Portsmouth**, Bank of the James** in Lynchburg and **Southern Community Bank & Trust** in Midlothian.

Towne Bank opened on April 8, 1999 with total capital of $37.0 million, and its Chief Executive Officer is G. Robert Aston, Jr. Bank of the James was authorized on May 28, 1999 with total capital of $9.4 million, and its Chief Executive Officer is James R. Hughes, Jr. Southern Community Bank & Trust was authorized on June 15, 1999 with total capital of $8.4 million, and its Chief Executive Officer is Jay H. Lowden, Jr.

In addition, two new Virginia bank applications are pending: Community First Bank, Forest (total capital $9.7 million) and Citizens Community Bank, South Hill (total capital $7.4 million).

## BANK ACCORD (continued from page 2)

acquired) met the five-years-of-operation criterion. That ruling cleared the way for the Commissioners' decision, after considerable deliberation, to treat the two states' laws as substantially reciprocal. Although Virginia law differs slightly in that it contains no age requirement in connection with the interstate acquisitions of branches, Commissioners Houston and Face will create a "level playing field" between the two states by requiring a Tennessee bank that proposes to acquire bank branches in Virginia to include at least one branch that has operated for over five years.

With the agreement letter of April 14, 1999, signed by the two department heads, Virginia now has established interstate branch-acquisition reciprocity with every state that borders the Commonwealth, though de novo branching into Tennessee still is not authorized by that state's law.

Questions on this subject may be directed to Commissioner Face (804) 371-9657 or Senior Counsel William F. Schutt (804) 371-9671 or Commissioner Houston (615) 741-2236.

## REGULATORY AND ACCOUNTING UPDATES

# CASH ITEMS NOT IN PROCESS OF COLLECTION

Cash items are frequently misreported in the quarterly Report of Condition and Schedule RC-A – Cash and Balances Due from Depository Institutions. Schedule RC-A is not filed by banks having less than $300 million in assets. Many institutions maintain only one cash items account on the balance sheet, and do not separate these into cash items in process of collection and cash items not in process of collection. Items in process are reported as "Cash," and items not in process are reported as "Other Assets." Call report preparers typically state two reasons for the misreporting: lack of a clear definition of cash items not in process of collection, and the concern that collection efforts might cease if these items are placed elsewhere on the balance sheet.

Cash items in process of collection include items such as cash letters, redeemed U. S. savings bonds and food stamps, and others individually listed in the call report instructions. Cash items not in process include bookkeepers' rejects, NSF checks, and credit or debit card sales slips in process of collection. This latter category also includes checks that are returned unpaid to the last endorser including "Account Closed," "Missing Endorsement," or "Stop Payment" items.

Banks with only one cash items account may wish to establish two accounts on their books to facilitate correct reporting. Cash items for which the bank has already received credit from another depository institution should be reported in the appropriate balances due from depository institutions account on Schedule RC-A. All overdrafts should be reported as loans, and not as cash items in process of collection or other cash items.

## UNIFORM POLICY ON THE CLASSIFICATION OF CONSUMER CREDIT REPLACED BY UNIFORM RETAIL CREDIT CLASSIFICATION AND ACCOUNT MANAGEMENT POLICY

Since 1980, the Uniform Policy on the Classification of Consumer Credit has provided a framework for classifying consumer loans. The revised policy, Uniform Retail Credit Classification and Account Management Policy, expands covered assets to include one-to-four-family residential loans and home equity lines of credit, and to establish classification standards for bankrupts, fraudulent accounts, and accounts of deceased persons. The statement also addresses re-aging, extensions, deferrals, renewals, and rewrites. A uniform system is being continued because retail credit generally is comprised of a large number of relatively small-balance loans, and evaluating the quality of the retail credit portfolio on a loan-by-loan basis is burdensome and inefficient.

Evidence of the quality of consumer credit soundness is best indicated by the repayment performance demonstrated by the borrower, and most classification guidelines in the policy are based upon past due status. A charge-off should generally be taken by the end of the month in which a mandated time period elapses.

The Uniform Retail Credit Classification and Account Management Policy includes the following:

- Open-end and closed-end retail loans past due 90 cumulative days are classified Substandard.
- Closed-end retail loans past due 120 days and open-end retail loans past due 180 cumulative days from the contractual due date should be charged off (e.g., classified Loss).
- Accounts in bankruptcy should be charged off within 60 days of receipt of notification of filing from the bankruptcy court, or within the policy statement's time frames, whichever is shorter, unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur. Any loan balance not charged off should be classified Substandard until the borrower re-establishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.
- Fraudulent loans should be charged off within 90 days of discovery or within the policy statement's time frames, whichever is shorter.
- Loans of deceased persons should be charged off when the loss is determined or within the policy statement's time frames, whichever is shorter.

(CONTINUED ON NEXT PAGE)

## REGULATORY AND ACCOUNTING UPDATES (continued)

- One-to-four-family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent should be classified Substandard. When a residential or home equity loan is past due 120 days for closed-end credit and 180 days for open-end credit, a current assessment of value should be made, and any outstanding loan balance in excess of the fair value of the property, less any costs to sell, should be classified Loss. Residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status.

- Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans for which the institution does not hold the senior mortgage, and that are delinquent 90 days or more, should be classified Substandard, even if the loan-to-value ratio is equal to or less than 60 percent.

If an institution can clearly document that a delinquent loan is well secured by marketable collateral, and in the process of collection such that collection will occur regardless of delinquency status, the loan need not be classified.

This policy does not preclude an institution from adopting an internal classification policy more conservative than the dictates of the policy statement. Policy statement users (institutions and examiners) are not precluded from using the Doubtful or Loss classification in certain situations if a rating more severe than Substandard is justified.

<u>Partial Payments on Open-end and Closed-end Credit</u>

Institutions should use one of two methods to recognize partial payments. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the institution may aggregate payments and give credit for any partial payment received.

<u>Re-aging, Extensions, Deferrals, Renewals, or Rewrites</u>

Re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. Use of these methods is acceptable when it is based on recent, satisfactory performance, and true improvement in a borrower's other credit factors, and when it is structured in accordance with the institution's prudent internal policies.

An account eligible for re-aging, extension, deferral, renewal, or rewrite should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.

- The account should exist for at least nine months before the borrower is allowed a re-aging, extension, renewal, referral, or rewrite.

- The borrower should make at least three "minimum due" consecutive monthly payments or the equivalent lump sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.

- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any 12-month period.

- No loan should be re-aged, extended, deferred, renewed, or rewritten more than two times within any five-year period.

Examiners will continue the practice of reviewing and classifying individual large-dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status. For call report purposes, changes that involve manual adjustments should be implemented for reporting in the June 30, 1999 call report. Changes requiring programming resources should be implemented for reporting in the December 31, 2000 call report.

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**www.state.va.us\scc\division\banking**

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