THE VIRGINIA STATE BANKER

Regulatory News for Virginia State-chartered Banks
State Corporation Commission - Bureau of Financial Institutions
Commissioner E.J. Face, Jr.
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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 strongly encouraged and should be addressed to:

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NEW BANKS ARE ON THE RISE !!

Mainly in reaction to recent bank mergers/acquisitions and an expanding economy, the number of new bank formations is increasing at a fast rate. In the first half of the current year, the Commission approved three new banks, and the Office of the Comptroller of the Currency gave preliminary approval to the formation of two new banks. Presently the Bureau of Financial Institutions is processing two additional applications for new banks, and we are aware of five other groups organizing new banks.

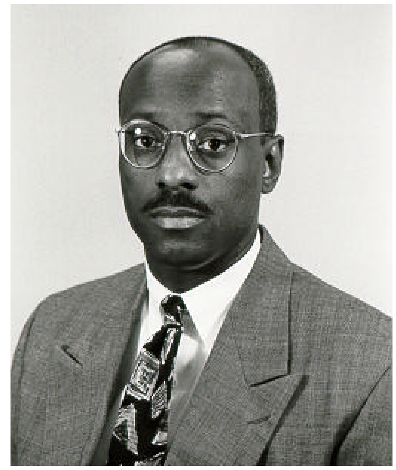
The newly approved state-chartered banks are located in Northern Virginia. They are: James Monroe Bank with $7.4 million in capital, headed by John Maxwell; Potomac Bank of Virginia with $8.8 million in capital, headed by Marshall Groom and G. Lawrence Warren; and Alliance Bank Corporation with $7.9 million in capital, headed by David Cordingly. At this time, the Bureau is processing an application by First Capital Bank to begin business in Henrico County with $7.6 million in capital, and New Peoples Bank, Inc. to begin business in Southwest Virginia with $11.1 million in capital.

Presently, there are 123 state-chartered banks in Virginia. Over the last ten years, the number of state-chartered banks ranged from 121 to 131, and they are expected to remain within that range. However, total assets of state-chartered banks have been increasing. As of March 31, 1998, total assets of state-chartered banks stood at $57.2 billion, compared with $32.4 billion at the end of 1987.

BUREAU EXAMINERS IN THE NEWS

BUREAU EXAMINER RICKY McCORMICK SELECTED TO TRAIN ZIMBABWE CENTRAL BANK EXAMINERS

The Education Division of the Conference of State Bank Supervisors (CSBS) has signed an agreement with the Reserve Bank of Zimbabwe (RBZ) to develop and implement a comprehensive training program for RBZ's bank examiners. The project, funded by the World Bank, includes nine weeks of on-site instruction and supervision by CSBS instructors in Zimbabwe. The Bureau's Ricky McCormick, Principal Examiner, is part of a select seven-member state examiner CSBS instructor team.



Ricky McCormick
Principal Examiner

"We're using every available educational tool and technology to bring high-quality, cost-effective training to developing countries like Zimbabwe, and help them create a strong bank regulatory environment," said Roger Stromberg, CSBS Senior Vice President for Education. "Using the Internet and CD-ROM-based multimedia, a student anywhere in the world can receive the same quality of training that we give our own students here in the United States," said Stromberg.

The first phase of the project requires Zimbabwean students to complete pre-course study using the CSBS Multimedia Library on PCs in Harare, Zimbabwe. The extensive material ensures that all students receive a solid foundation in examination fundamentals. Students will also use the Internet to enroll in the CSBS Online University.

The second phase consists of three weeks of intensive classroom training by CSBS instructors in Zimbabwe, and concentrates on applying the fundamentals learned in the pre-course study to real world examples. The final phase consists of six weeks of actual bank examinations in Zimbabwe. This method allows RBZ examiners, working under the guidance of experienced CSBS instructors, to apply the principles learned in the first two phases. The seven-member team of CSBS staff and instructors will rotate to Zimbabwe in three-week shifts.

"The opportunity to work in a developing country can't help but give our instructors a better insight into the origins and workings of the financial system in our own country," said Neil Milner, President of CSBS. "Plus, we hope their experiences can help RBZ examiners avoid the mistakes and omissions that can cause major shifts in a fragile economic system."

"When Roger Stromberg called and requested the services of Ricky for this project, I couldn't say 'Yes' fast enough," said Bureau of Financial Institutions Commissioner E. J. Face, Jr. "The fact that Ricky was selected from a pool of hundreds of state examiners across the country is a tribute to both Ricky and the Bureau," said Face.

Robert P. Bishop
Principal Examiner

BUREAU EXMINER ROBERT BISHOP RECOGNIZED FOR BANKING SCHOOL ACHIEVMENT

Principal examiner Bob Bishop was recently recognized as one of the top achievers in the Junior class at The Graduate School of Banking at Louisiana State University in Baton Rouge.

VIRGINIA TRUST BUSINESS IS GROWING

Trust activities in the Commonwealth continue to flourish. Growth in this segment of the financial services industry appears to have come from two principal sources. The securities markets continue their robust performance so far during the decade of the nineties, and there has been a renewed appreciation of fiduciary services both by banks and by customers. These factors, coupled with new products and services being offered, and the attractiveness of non-interest fee income, have all contributed to brightening the fiduciary landscape.

Trust data at year-end 1997 compiled by the Bureau reflected that the fiduciary enterprises under our regulatory supervision have under administration $36.1 billion in various capacities. Approximately $17.2 billion is in accounts where the institutions have discretionary authority, and $18.9 billion is held in ministerial capacities. The total accounts involved number over thirty-five thousand. Year-end figures relating to trust income are available only for larger enterprises, with most observers agreeing these dollars are a significant contribution to the institutions' bottom lines

Enterprises in the Commonwealth administering this large amount of wealth and supervised by the Bureau number thirty-three. Bank trust departments, at twenty-nine, outnumber other fiduciary service providers. Next, there are two state-chartered independent trust companies operating in Virginia, plus an affiliated trust company and one subsidiary trust company.

As you can see, Virginia has multiple organizational structures in which trust services may be offered. The well-known bank trust department is, of course, the most familiar; but in the last few years, affiliated, independent, and subsidiary trust companies have all become active and well serve the needs of their customers. Remember, trust activities in the Commonwealth continue to flourish.

An interesting fact is that at year-end 1997, banks nationwide had assets totaling $5.1 trillion while bank trust activities totaled $17.7 trillion.

YEAR 2000 TESTING MILESTONES

We're rounding the third turn toward Year 2000 compliance. The most important work -- TESTING -- if not already underway is about to begin for most institutions. Testing is the most critical phase, and is likely to account for more than 50% of the time, cost, and personnel of Year 2000 preparations. A snapshot of the testing milestones set by regulators appears as follows:

<u>June 30, 1998</u>

Institutions should complete the development of their written testing strategies and plans.

<u>September 1, 1998</u>

Institutions processing in-house and service providers should have commenced testing of internal mission-critical systems, including those programmed in-house and those purchased from software vendors.

<u>December 31, 1998</u>

Testing of internal mission-critical systems should be substantially complete. Service providers should be ready to test with customers.

<u>March 31, 1999</u>

Testing by institutions relying on service providers for mission-critical systems should be substantially complete. External testing with material other third parties (customers, other financial institutions, business partners, payment systems providers, etc.) should have begun.

<u>June 30, 1999</u>

Testing of mission-critical systems should be complete, and implementation should be substantially complete.

HAVE YOU HEARD??

4-Day Work Week for Examiners

In 1996, the Bureau embarked upon a new path ... for institutions willing to make personnel and workspace available for 10 hours per day rather than the standard 8 hours per day… a 4-day in-the-bank work week rather than a 5-day in-the-bank work week. Bankers were surveyed, and the survey results are used to schedule examinations as 4-day or 5-day. Have you changed your mind from your survey response? Just discuss it with the Bureau examiner who calls to inform you of an upcoming examination. By the way, of those returning the survey, more than 90% said yes to the 4-day work week.

Our reason for trying the 4-day week was simple -- to reduce turnover. Individuals leaving our employ usually cite frequent travel as the reason. And there are also benefits for the institution. Although we try to make examinations as unintrusive as possible, they do require time of your personnel -- although the number of hours is the same, one less day of examiners during the week, we have been told, is definitely a plus.

And the 4-day work week for examiners idea has spread. Our colleagues at the Federal Reserve Bank of Richmond adopted a similar schedule earlier this year.

SAME REQUIREMENTS FOR INTERSTATE AND INTRASTATE ACQUISITIONS

Effective July 1, 1998, interstate and intrastate acquisitions of Virginia banks will be subject to the same requirements. Amendments to Chapter 15 of Title 6.1 of the Virginia Code passed by the Virginia General Assembly and signed by the Governor place acquisitions of Virginia banks by out-of-state bank holding companies at the same footing as acquisitions of Virginia banks by Virginia bank holding companies. The equal treatment of intrastate and interstate acquisitions by the states is mandated by the Riegle-Neal Interstate Banking and Branching Efficiency Act.

Pursuant to the amendment, the requirements of Chapter 13 (intrastate acquisitions) will apply to Chapter 15 applications (interstate acquisitions by out-of-state bank holding companies). The Bureau has revised the Chapter 15 application forms, incorporating the changes.

RECENT ANNOUNCMENTS

Commissioner Face has been elected to the Board of Directors of the Jumpstart Coalition, a national organization to improve financial literacy among high school students.

The 1999 Annual Meeting of the Conference of State Bank Supervisors (CSBS) will be held at the Williamsburg Lodge on June 2 through 6, 1999.

Commissioner Face will be serving on the CSBS Legislative and Regulatory Committees. Deputy Commissioner John Crockett will be serving on the CSBS Education Committee, and Deputy Commissioner Nick Kyrus will be serving on the CSBS International Banking Committee.

LAW CHANGE ON CAPITAL STRUCTURE OF NEW BANKS

An amendment to Section 6.1-13 of the Virginia Code requires paid-in capital of new banks to be divided between capital and surplus rather than among capital, surplus, and reserve for operations. The elimination of the reserve for operations will be compatible with generally accepted accounting principles.

Under the new requirements, a new bank would allocate its capital between capital and surplus. Profits or losses will be recorded under undivided profits (losses). Thus, the number under undivided profits (losses) will reflect more accurately the profitability of a new bank. Application forms for new banks have been revised, incorporating the amendment.

Management succession is an item that comes up for discussion from time to time during examinations. It is one of many factors that are considered in evaluating management. It is often a sensitive subject since it deals with something a lot of us prefer not to deal with or even think much about – a change in the status quo. The following is an article on this topic (reprinted with the permission of David H. Baris at the American Association of Bank Directors) we thought you might find interesting:

MANAGEMENT SUCCESSION: DO YOU REALLY NEED A PLAN?

David H. Baris, Esquire, General Counsel
Gregory C. Golembe, Executive Director
American Association of Bank Directors
Bethesda, MD 20814

April 3, 1996 was a landmark in the annals of management succession events. On that date, an airplane carrying Commerce Secretary Ron Brown crashed on a mountainside in Bosnia. Secretary Brown was accompanied by 12 CEOs of companies of various sizes, industries, and ownership structures. In that one instant, a major government department and 12 U.S. companies lost their leaders, and for the directors and managers of those organizations, succession moved from theory to reality.

Bank boards of directors have a clear and unambiguous responsibility to ensure that strong, competent management is running their institutions. Directors are driven not only by the business imperative of good management being the key to the bank's success -- which for many directors impacts their personal portfolios as well -- but also by the regulators who make it clear where the ultimate responsibility lies. While succession planning is a management function, it is one of those undertakings – like Y2K compliance – in which the Board must take a direct interest to ensure that proper steps are being taken. At the same time it is an excellent hedge against director liability where, as Douglas Austin points out, "Competent, well-rewarded, stock-optioned senior management is the best kind of defense for your safety as a director."

Yet, not all banks have a formal management succession plan. A recent survey of community banks by the American Bankers Association showed approximately one third without a formal plan. The 1998 Survey of Bank and Savings Institution Directors by the American Association of Bank Directors had similar results, but the survey sample covered banks and savings institutions of all sizes. Even more broadly, a Korn/Ferry survey of several years ago yielded similar results among industrial, manufacturing and other non-financial services industry companies, though there is some evidence that this is changing since Secretary Brown's crash.

While regulators like to see written succession plans, it does not seem to be an issue that is emphasized with healthy institutions. As one regulator told us, " If the bank is in good shape and we are comfortable with management, we won't push the issue."

But directors should -- at least to a point.

There are lots of bad reasons for not having a succession plan, ranging from simple low priority in busy schedules to CEO uneasiness at the prospect of planning for his or her own demise. On the other hand, lack of a formal plan may reflect a strong management team in place and fully capable of continuing in time of change at the top, or it may be consistent with a specific business strategy that is fully endorsed by the board. So not having a written plan may not be a bad thing, but directors should look at the issue at least annually to ensure that management continuity is addressed either formally or informally, and for the right reasons.

Plane crashes and other catastrophic events test the resiliency of a company's management succession in a high stress environment similar to a disaster recovery situation. It is useful to remember that most planning anticipates benign situations, events like retirement, or job change, or the CEO winning the lottery and heading for a South Seas island. While generally focusing on the CEO, comprehensive succession planning extends to multiple layers of management, particularly the "skill" positions, and may be incorporated in the training and education program. Whatever the circumstances, directors must evaluate current management, in part, in terms of what will happen if it is no longer there.

Succession should be a board meeting agenda item at least annually, though it may be a sub-item of a related subject such as management development (training and education) or, perhaps, a review of the strategic plan. There are eight "Critical Areas" that should be considered in a succession plan review: strategic plan, timing, ownership, skills, size, staff development, condition of the bank, and the CEO. Not all are relevant to every institution, but it is useful to consider each, checking off those that do not apply and addressing those that do.

Strategic Plan - Be sure that the management succession plan is consistent with the bank's overall strategy. For example, if the short-term strategy involves selling the bank, a complex succession and transition program may not be necessary.

Timing - A CEO's announced plan to depart or retire (mandatory or otherwise) makes succession planning a more straightforward exercise. Directors should be concerned in these situations if a well-conceived transition plan is not in place or if management's plan runs afoul of one or more of the other critical factors. Timing may also refer to external events such as economic trends or, again, prospective sale of the bank, or imminent legal or regulatory actions. Directors must be aware of what is happening within the bank's immediate environment at all times.

Ownership - This is an issue for closely held and family run institutions. The board should have a clear sense of what the owners have in mind in terms of future leadership and their level of flexibility. One of the companies deprived of leadership following the Secretary Brown crash was a family owned service firm where control passed to the widow. She had to make some hard decisions on the distribution of equity to attract the quality of replacement management to save the firm but resulted eventually in loss of family control.

Skills - Directors should have a precise understanding of the CEO's role and responsibilities in the bank and a sense of whether those same needs are expected to continue. For example, in community banks, the CEO may wear a number of different hats from chief loan officer to head of marketing. As staff develops, the next CEO may not need to have the same hands-on set of skills or he/she may need an entirely new set of skills consistent with changing markets, anticipated new product offerings, or to deal with the shifting competitive environment. Essentially, directors need to assess what needs will be required in the future of the bank.

Size - The bank size is an important component of management succession consideration. The larger the institution, the greater the flexibility to "home grow" management.

Staff Development - Regular assessment of the development of junior staff, skill levels attained and potential for future leadership is important. Succession strategies are often built around the time required for junior staff to develop. Alternatively, the presence of a mature, experienced staff behind the CEO allows for other approaches. The key is for the directors to be up-to-speed on these developmental issues.

Condition of the Bank - The condition of the bank is sometimes the reason for a change at the top. There may be situations where the regulators play an important role in the selection of the next CEO, requiring specific skills to remedy problems.

CEO - In most cases, the CEO will play a key role in the selection of a successor and in developing the plan under which the bank will continue to operate in the event of a sudden inability to perform his or her duties. In fact, there is no single individual who understands the requirements of the job better than the incumbent. Still, it is the board's responsibility to make the selection.

There is no formula for a strategy to emerge from the board's analysis of these eight critical factors. Each institution is unique and the best that can be said is that the resultant strategy is likely to represent the sum of the board's analysis. Typically management and the board adopt one of three general strategies though there are multiple permutations within each. The first strategy is sometimes called "Head in the Sand" or "We'll Cross that Bridge when We Come to It" which is to have no plan. Clearly a third of all banks are engaging in some form of this approach. If the regulators are acquiescing to this situation, it is likely to be a good institution. This is probably not a problem so long as the board is reviewing the approach (or lack thereof) at least annually.

"Pick a Successor" or "Pick a Successor Pool" is another popular approach. A successor pool is most common in larger institutions where three or four senior executives will be put in competition for the eventual top spot. The resulting competition is good for the bank but once the selection is made, the also-rans generally leave the bank, taking with them valuable knowledge and experience. Naming a successor is common, particularly when there is at least an approximate date for the current CEO's departure.

The named successor can be molded in the right image and staff, shareholders, and the market can take a level of comfort from the organizational stability. The bank should take care not to name a successor – officially or (Continued on Page 7)

New Interagency Policy Statement on Securities and End-User Derivative Activities ... Questions & Answers

The newly issued FFIEC Policy on Investment Securities and End-User Derivatives was effective May 26, 1998 (the 1998 Statement). Published for comment last October, the 1998 Statement replaces the 1992 Supervisory Policy Statement on Securities Activities (the 1992 Statement). But don't toss your copy of the 1992 Statement -- it contains information still useful. Here's a discussion of the major changes.

Q. Have the constraints on investing in mortgage derivative products deemed "high risk" been eliminated?

Yes. Under the 1998 Statement, the appropriateness of any investment must be evaluated using a variety of factors, especially the institution's ability to measure and manage the associated risks.

Q. Can institutions stop testing mortgage derivative products to determine "high risk" status?

No. The call reports still require reporting of high-risk mortgage securities on Schedule RC-B. The instructions for this reporting include the language from the 1992 Statement.

Q. Despite the lack of a testing requirement for investment purposes for mortgage derivatives, are there situations in which institutions are expected to tests these and other portfolio investments?

Yes. Institutions should know the value and price sensitivity of all investments prior to purchase and on an ongoing basis. Policies should specify the types of market risk analyses that should be conducted for various types of instruments, both at acquisition and on an ongoing basis. In addition, policies should specify any required documentation needed to verify the analysis.

But not all investments need to be subjected to pre-purchase analysis. Relatively simple or standardized instruments, the risks of which are well known to the institution, would likely require no or significantly less analysis than would more volatile or complex instruments.

Q. What are end-user derivatives?

Off-balance sheet items such as swaps, forwards, and options not held in trading accounts.

Q. Does the 1998 Statement increase the responsibilities of boards of directors?

Yes. Some commenters stated the 1998 Statement places "excessive" obligations on the board of directors. However, the statement merely reflects the risk-based framework of recent regulatory issuances. Among the elements of the framework are active board and senior management oversight. The 1998 Statement reaffirms the board's responsibility to approve policies for conducting investment activities. Further, the board should periodically review portfolio activity, and require that management demonstrate compliance with approved risk limits. However, boards are not expected to review and approve the securities dealers with whom the institution conducts business. The 1998 Statement permits the board to delegate the authority for selecting dealers and establishing dealer limits to senior management. Board members and senior managers may find the 1992 Statement's guidance on Selection of Securities Dealers helpful.

Q. Does the 1998 Statement introduce any new concepts?

Although not a new concept, total return is endorsed as a useful supplement to price sensitivity analysis for evaluating the returns of an individual security, the investment portfolio, or the entire institution.

For a complete copy of the policy statement, contact our office or visit the FFIEC website at www.ffiec.gov.

MANAGEMENT SUCCESSION

(Continued from page 6)

unofficially – too far in advance of the CEO's departure. Banks, people, and circumstances change, making a good candidate in year one somewhat less attractive by year five.

Finally, many banks take the "Process" approach. This can be as simple or complex as the bank's needs require. The process should be developed by the senior management staff, but reviewed and, if possible, put through hypothetical testing annually by the board. At a minimum, a process requires that someone be put in charge immediately, if only on an acting basis and that there is a specific schedule for finding a new CEO. A valuable board exercise is to look at who might be available in a short-term situation. A board member, a recently retired CEO, current staff, or even staff from competitor banks should be kept on a list of possibles and updated regularly.

Conclusion

Management succession and succession planning should be handled by the CEO and senior staff, but it should be watched closely, evaluated, and tested by the board of directors since it, like the bank, must live with the results of this plan.

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