THE VIRGINIA STATE BANKER

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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 welcome and should be addressed to:

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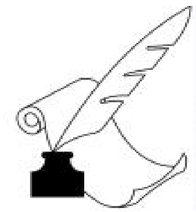
1999 GENERAL ASSEMBLY SESSION



This year the Bureau of Financial Institutions offered a legislative package with four bills affecting banks, savings institutions, credit unions, and check cashers. The Bureau considered a number of other proposals, but narrowed its package to just four bills for the short 45-day General Assembly Session.

As of February 9, 1999, the midpoint of the Session, the Bureau had reviewed and/or commented on some 70 bills or resolutions affecting financial institutions, bills involving subordinate mortgage loans, credit insurance, pawnbrokers, joint accounts, real estate settlement, electronic filing of information, money laundering, fingerprinting, legal investments for public funds, uniform principal income, liens on financial institutions, Year 2000, assuming the identity of another person, charges under closed-end installment plans, manufactured homes, purchases of licenses and permits with credit cards, community property, access to criminal history, medical savings accounts, and bank franchise tax.

After much consideration and thought, the Bureau offered Senate Bill 1019 which will amend the Virginia Credit Union Act. In 1998, the U. S. Congress passed the Credit Union Membership Access Act which expanded credit union membership. Effectively, the Act disadvantaged Virginia's 77 State-chartered credit unions versus Virginia's 187 federally chartered credit unions with respect to multiple membership groups. SB 1019 will bring State-chartered credit unions "up to par" with federal credit unions. It does not afford State credit unions any more powers than those permitted federal credit unions under federal law. It offers a "level playing field" and preserves the dual chartering system for credit unions in Virginia. In crafting the bill, the Bureau was careful to preserve its regulatory flexibility and not be tied to a federal regulatory standard since it is responsible for regulating and supervising all State-chartered depository financial institutions.

The Bureau worked closely on SB 1019 with the Virginia Bankers Association and Virginia Credit Union League. The Bureau thanks the VBA for not opposing the bill.

The other three Bureau-proposed bills are:

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Year 2000 Contingency Planning

Business resumption contingency planning is critical because, notwithstanding a financial institution's successful efforts to thoroughly renovate, validate, and implement Year 2000-ready systems, the potential exists that systems will not operate as expected. Financial institutions are expected to substantially complete their Year 2000 business resumption contingency planning process by June 30, 1999. The plan should be reviewed and approved by the board of directors, validated, and updated as needed.

The Year 2000 business resumption contingency plan may be a supplement to an existing disaster recovery and business continuity plan. A supplement, or an entirely separate plan, may be necessary because existing plans do not address contingencies unique to the Year 2000 problem. For example, an existing plan may contemplate using a back-up site if a problem occurs; but because a Year 2000 problem may involve either software or hardware failures, resorting to a back-up site that uses the same hardware or software may not remedy the problem. Plans must capture Year 2000-related risks.

To recap the May 1998 interagency guidance on contingency planning, Year 2000 business resumption contingency planning involves four phases:

establishing *organizational planning guidelines* defining the business continuity planning strategy;

completing a *business impact analysis* which assesses the potential impact of mission-critical system failures on the core business processes;

developing a *business resumption contingency* plan; and

designing a method of *validation* so the business resumption contingency plans can be tested for effectiveness and viability.

Financial institutions should establish a coordinated crisis management process for responding to Year 2000 disruptions that addresses communications among managers, staff, customers, and third-party suppliers. The plan should assign responsibility for implementation to specific individuals; designate key personnel who are responsible for carrying out specific tasks; and outline a program for notification of involved parties, including employees, customers, and third parties. <u>A strategy to respond promptly to customer and media reaction should also be established, and management should consider how to respond to events outside the financial institution's control that could substantially affect customer confidence</u>.

A financial institution should develop a method to test its Year 2000 business resumption contingency plan and assign responsibility to an individual or group to execute the validation process. Examples of validation methods include, but are not limited to, simulations, role play, walk-throughs, and alternate site reviews.

Contingency Liquidity Planning

A financial institution should consider whether it could experience unusual funding needs in late 1999 and early 2000 arising from deposit outflows or loan demand. The contingency liquidity plan may include expanding normal liquidity sources as well as establishing contingent and/or alternative sources. Consideration should be given to scenarios that would result in short-term or longer-term liquidity problems. Early warning measurements could be used to detect changing funding requirements.

As part of the contingency liquidity planning process for the century date change, financial institutions should consider the probable cash demands of their customers and determine whether they need to arrange for additional cash reserves. A financial institution also should consider how quickly it can obtain additional amounts of cash should its reserves be reduced unexpectedly.

Further, a financial institution should evaluate the potential for disruptions in its cash distribution systems and develop

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PROSPECTS FOR NEW BANKS*

By Nicholas C. Kyrus, Deputy Commissioner of Finanacial Institutions, Corporate Structure and Research

In the last two years, 23 groups have announced the organization of a new bank in Virginia. This is neither unique to Virginia, nor new. Other states are also experiencing a high number of new bank formations, and similar waves rippled through the Commonwealth in the 1970s and the late 1980s. A look at Virginia's banking history may help us understand the present interest in new banks and allow us to make some general observations about their prospects.

Reasons for Bank Formations

Historically, new banks in Virginia have opened in clusters. An examination of bank formations in the last 30 years shows three clusters of new bank openings – the 1970s, the late 1980s, and the late 1990s. New bank formations in the 1990s were fewer than in the 1980s and much less than in the 1970s. In the 1970s, new bank openings ranged from four to fifteen per year, in the 1980s they ranged from one to nine per year, and in the 1990s from zero to eight per year. On average, five new banks have opened per year in the last 30 years.

The large number of bank formations in the last 30 years has been triggered by an increasing number of bank acquisitions and consolidations, economic growth, a booming stock market, and legislative changes. In the 1997-98 period, a number of large Virginia banks were acquired by and consolidated with out-of-state banks. The acquisition of Virginia banks by out-of-state banks was facilitated by federal and State legislation in the mid-1990s, which allowed out-of-state banks to merge their Virginia subsidiaries into their home offices and operate them as branches. In the 1997-98 period alone, 45% of Virginia bank deposits came under the control of out-of-state banks and holding companies, increasing the total of Virginia deposits held by out-of-state banks and holding companies to about 60% of the market. Furthermore, during the same period, a relatively high number of intrastate acquisitions were also announced. These acquisitions and consolidations reduced the number of banking competitors and provided an impetus for the organization of new banks.

The present interest in new bank formation was also fueled by the longest economic expansion since World War II and record stock prices, which raised expectations and investor confidence. This helped organizers raise high amounts of bank capital without much difficulty. A continuing strong economy would also allow new banks to grow rapidly, minimizing initial losses and allowing profitablity in a short period of time.

New bank formations in the late 1980s also were preceded by a large number of intrastate consolidations in preparation for interstate banking. A 1985 amendment to the Virginia Banking Act allowed for the first time acquisitions of banks across state lines. This period marked the beginning of the entry into Virginia by out-of-state banks, an invasion that is continuing today.

New bank formations in the 1970s were preceded by the highest number of mergers and acquisitions in Virginia history. Merger activity was triggered by legislative changes in the 1960s that allowed the formation of bank holding companies and Statewide branching through mergers. Many of the new banks of the 1970s were established by holding companies seeking to serve more distant markets. At that time, they could not serve such distant markets with branches because of branching restrictions imposed by the Banking Act.

Past Performance

The vast majority of new banks organized in Virginia over the last 30 years have been successful. Most of them became profitable within two to three years of beginning operation. However, about two-thirds of new banks merged with larger banks. In most cases, the sale of new banks commanded prices well above book value, especially for new banks that were located in metropolitan areas. Only five of the 160 banks organized in Virginia over the last 30 years have failed. These failures were associated with mismanagement rather than the lack of growth or excessive competition. The bank failure rate was much lower in Virginia than in the United States or on the East Coast.

Current Bank Formation and Characterestics

Current new bank formations are concentrated mainly in the highly or densely populated metropolitan areas of the Commonwealth. In fact, 20 of the 23 organizing banks are in metropolitan areas. Although the large majority of start-up banks are concentrated in metropolitan areas, high population and economic growth in these areas will enhance their prospects for success. The Northern Virginia Metropolitian Statistical Area (MSA) accounts for seven of the new banks and the Richmond MSA accounts for five. In addition, three new banks were organized in the Norfolk-Newport News MSA, two in the Lynchburg MSA, two in the

(Continued on Page 5)

*Editors Note: Reprinted from the 1999 first quarter issue of *Directives*, a quarterly publication of the Virginia Association of Community Bankers

GENESYS (General Examination System)

GENESYS is an integrated software application for recording financial institution data and creating an examination report. It includes spreadsheets, worksheets, and report pages. The application is used onsite during an examination for portions of the examination process and for report preparation. Reviewers also use GENESYS to review completed reports.

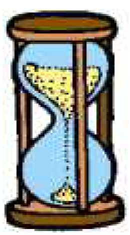
The application was developed to provide examiners with one location where the majority of examination information can be used and viewed, and to maximize the use of available technology. The FDIC originated the GENESYS project in December 1995. It became a collaborative effort in January 1997 when the Conference of State Bank Supervisors and Federal Reserve System agreed to this platform.

The application provides some efficiencies. Data entered or changed in one part automatically feeds to linked areas, eliminating the need for re-entry of the same data. And several examiners can use the same data to perform their assignments and prepare different parts of the examination report.

GENESYS is the third in a series of interagency regulatory tools. These tools are being jointly developed and used by the states and the federal agencies to streamline examinations and provide more consistent examinations, procedures, and reports. The Bureau began using the ELVIS (now ED) workpaper documentation tool last year. (ELVIS was renamed ED following a complaint from the folks at Graceland). We continue to monitor developments with the ALERT application but have not yet started using this product. ALERT partially automates the loan review process and requires a financial institution to provide the examining agency with loan data on media such as disks or tape.

Twenty-nine state banking departments began using GENESYS after its initial release late in 1998. Nearly all of the remaining departments (including Virginia) are adopting GENESYS during the first half of 1999. Our implementation was timed to coincide with Federal Reserve Bank of Richmond's implementation, as the majority of banks in Virginia belong to the Federal Reserve System.

As with the adoption of new processes and software, we expect some challenges. We are planning carefully and training intensively to ensure smooth implementation. We do not anticipate any expansion of onsite time to accommodate this new tool.



TRIAL UNDERWAY TO REDUCE EXAMINATION "ONSITE TIME"

The Bureau has never officially surveyed bankers on their opinions about examination length, but we're sure most would say having examiners in the bank for a shorter time period is desirable. Reducing onsite time is an attractive goal, but the challenge is in maintaining examination quality and integrity.

Our "Less Time Onsite" examination requires an institution to send us, in advance, much of the data requested to be available at the start of an onsite examination. This information is digested by the examination team in Bureau offices prior to the onsite examination, and the team completes all tasks that can be done without being physically at the institution. The goal is to lower onsite time by as much as 30%. The bank has only the additional burden of sending the information to us, as the information would need to be prepared for the examination anyway.

Early results of this trial have been generally positive on both sides – bankers and examiners. Please pass any comments along to Deputy Commissioner John Crockett or the examiner in charge.

PROSPECTS FOR NEW BANKS (continued from page 3)

Charlottesville MSA, and one in the Roanoke MSA. Furthermore, community banks were organized in Winchester, South Hill, and Honaker in Russell County.

Eight of the twenty-three organizing banks opened for business in 1998. These banks are: (1) Alliance Bank Corporation, Fairfax County; (2) James Monroe Bank, Arlington County; (3) Potomac Bank of Virginia, Fairfax County; (4) Cardinal Bank, N.A, Fairfax County; (5) Virginia National Bank, Charlottesville; (6) Albermarle First Bank, Albermarle County; (7) First Capital Bank, Henrico County; and (8) New Peoples Bank, Inc., Honaker, Russell County. The Bank of Williamsburg opened for business in February 1999.

The level of capitalization of these new banks is relatively high. With the exception of two holding company subsidiary banks, proposed capitalization ranged from $6.9 million to $37.0 million, with the average being around $10.0 million. Higher capitalization provides cushion for early operating losses and for loan losses in case of an economic downturn. Furthermore, higher capitalization allows early expansion by branching and, of course, larger loans. It is anticipated that most of the new banks will try to establish branches in order to grow and benefit from economies of scale. Thus, banking competition among community banks is expected to intensify.

Despite tougher organizing standards for State-chartered banks, 17 of the 23 organizing groups sought State-charters rather than national charters. State-chartered banks are required to obtain subscriptions for their stock prior to applying for a certificate of authority to commence business. Also, State-chartered banks in organization are prohibited by statute from using brokers to market their initial stock offering and are encouraged to sell their stock to a large number of individuals living or working in the area they plan to serve. These requirements prevent speculative ventures and allow local communities to vote with their dollars, giving support to organizing groups that have the locality's confidence and trust. With the full support of the community, new banks stand a better chance of succeeding in this highly competitive world.

Quality management and direction are perhaps the most important elements for the success of new banks. The Virginia Bureau of Financial Institutions ensures that new banks are managed by individuals with successful track records at the chief executive officer level. Furthermore, the Bureau strongly encourages organizing groups to include experienced bank directors on their boards who are knowledgeable and represent a cross section of the community. Although there is no substitute for experience, the Bureau is planning together with the Federal Reserve Bank of Richmond, a "bank director's college." Manned by regulators and experienced bankers as instructors, the college will hold seminars for existing and new directors of Virginia banks.

A well-rounded board provides important perspective and objectivity in evaluating management recommendations and formulating bank policies. With quality management and enlightened boards, new banks in Virginia will continue to provide quality service to their communities and high returns to their stockholders. If history is a guide, the prospect for the success of a new bank in Virginia is good.

GENERAL ASSEMBLY (continued from page 1)

1. **HB 1879** – amend §§6.1-433 and 6.1-435 to require check cashers to give prompt notice of office openings, closings, and relocations, and to require an annual fee to defray the costs of regulation and supervision.
   Patron - Keating

2. **HB 1938 –** amend §6.1-194.12 to remove the requirement of establishing a separate capital account labeled "reserve for operation" before a savings institution receives a certificate of authority from the SCC.
   Patrons - Morgan and Keating

3. **SB 897** – amend §6.1-58.1 to clarify that all controlled subsidiaries of banks whether domestic or international may charge interest, fees, etc. as its parent bank can charge. **Patron – Holland**

Two other bills are being followed closely by the Bureau – HB 2250 which amends §6.1-39.3 on bank branching and HB 2251 which adds §§6.1-32.31 through 6.1-32.45 to allow multi-state trust institutions. These were issues under consideration by the Bureau for inclusion in its legislative package; however, other interested parties proposed these bills after discussions with Bureau senior staff. The Bureau offered significant amendments to each bill, and consensus among all interested parties was reached prior to consideration by General Assembly Committees.

HB 2250 will enable the Bureau to further streamline its bank branching application process while HB 2251 will allow multi-state interstate trust operations on a reciprocal basis, paralleling Riegle-Neal interstate banking statutes. The Bureau believes its amendments preserved its regulatory responsibilities while modernizing existing law.

Questions about any legislation affecting financial institutions can be directed to Commissioner Face or Senior SCC Counsel William F. Schutt (804/371-9671). To read or check the status of any bill before the Assembly, go to http://leg1.state.va.us/lis.htm on the internet.

REGULATORY AND ACCOUNTING UPDATES

Nonmortgage Sevicing Assets Now Includible in Regulatory Capital

Before October 1, 1998, nonmortage servicing assets were excluded from Tier 1 capital. After this date, the maximum amount of servicing assets when combined with purchased credit card relationships (PCCRs), includible in regulatory capital increased from 50 percent to 100 percent of Tier 1 capital. Servicing assets include mortgage servicing assets (MSAs) and nonmortgage servicing assets (NMSAs). A further sublimit of 25 percent of Tier 1 capital applies to the aggregate amount of NMSAs and PCCRs. In addition, the rule subjects the valuation of MSAs, NMSAs, and PCCRs to a 10 percent discount.

Beginning with the March 31, 1999 Report of Condition, banks should report NMSAs as part of "Purchased credit card relationships and nonmortgage servicing assets" in Schedule RC-M, item 6.b.(1). On Schedule RC-R — Regulatory Capital, banks may recognize NMSAs in accordance with the new provisions.

Call Report Changes for 1999 Announced

The FFIEC has approved a limited number of revisions to the Reports of Condition and Income (Call Reports) for 1999. Most of the revisions are instructional. Revisions are subject to approval by the U.S. Office of Management and Budget, and are provided in advance to assist institutions in planning for the changes.

The changes include:

Elimination of the items in the securities schedule related to high-risk mortgage securities;

New items for accumulated gains (losses) on cash flow hedges to the equity capital section of the balance sheet and to the changes in equity capital schedule (necessitated by Statement of Financial Accounting Standards No. 133, *"Accounting for Derivative Instruments and Hedging Activities*);

Expansion of the scope of the existing item for purchased credit card relationships in the memoranda schedule to include nonmortgage servicing assets (see related article above);

Conforming the instructions for "internally developed computer software" and "organization costs" with accounting pronouncements issued during 1998 (AICPA Statements of Position 98-1 and 98-5, *"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use"* and *"Reporting on the Costs of Start-Up Activities"*;

Instructional guidance on the reporting of securities activities, including descriptions of unsuitable investment practices previously discussed in the 1992 Policy Statement on Securities Activities;

Revision of the instructions for reporting "net risk-weighted assets" for banks subject to the market risk capital guidelines; and

Clarifying the instructions for charged-off loans, goodwill, and the Tier 2 capital limit on the loan loss allowance in low level recourse transactions.

Assuming approval (which is likely), the revisions will take effect as of the March 31, 1999 report date. In the March reports, banks may report a reasonable estimate for any new or revised item for which the requested information is not readily available.

REGULATORY AND ACCOUNTING UPDATES (continued)

Tax Allocation in a Holding Company Structure

Effective November 23, 1998, the *Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure* provides guidance to institutions regarding the allocation and payment of taxes among a holding company and its financial institution subsidiaries. This Statement replaces the separate issuances of federal agencies on the same subject.

The Statement reaffirms that intercorporate tax settlements between an institution and the consolidated group should result in no less favorable treatment to the institution than if it had filed its income tax return as a separate entity. Tax remittances from a subsidiary institution to its parent for its current tax expense should not exceed the amount the institution would have paid had it filed separately. Payments by a financial institution subsidiary to its parent should not be made before the subsidiary would have been obligated to pay the taxing authority had it filed as a separate entity. Similarly, an institution incurring a tax loss should receive a refund from its parent in an amount no less than the amount the institution would had received as a separate entity. Regardless of the methods used to settle intercorporate tax liabilities, financial institutions must provide for current and deferred taxes in their call reports in amounts that would be reflected as if the institution had filed on a separate entity basis.

A holding company and its subsidiaries should enter into a written tax allocation agreement. The agreement should be approved by the parent company and subsidiary boards of directors. An agreement should:

- Require a subsidiary financial institution to compute its taxes (current and deferred) on a separate entity basis
- Discuss the amount and timing of the institution's tax payments for current tax expense, including estimated tax payments
- Discuss reimbursement to an institution when it has a loss for tax purposes; and
- Prohibit the payment or other transfer of deferred taxes by the institution to another member of the consolidated group.

Agreements currently in existence already deemed acceptable by examiners need not be rewritten as long as the substance of the agreement captures the preceding points. Forgiveness by a parent of subsidiary taxes, and adjustments for statutory tax considerations and the alternative minimum tax are also discussed in the Statement. The background information is particularly helpful in understanding the Statement, and should be read in conjunction with the Statement.

The Bureau examines a holding company and its subsidiaries concurrently, and our examiners routinely review arrangements and transactions between a holding company and its banking subsidiaries for compliance with laws and other regulatory issuances.

UPDATED UNIFORM RATING SYSTEM FOR INFORMATION TECHNOLOGY

Previously announced changes to the Uniform Rating System for Data Processing Operations (URSDPO) have been adopted. The new Uniform Rating System for Information Technology (URSIT) replaces URSDPO which was first adopted in 1978. The rating system is one of three interagency rating systems used by the Bureau and federal agencies to uniformly assess the soundness of financial institutions /1, fiduciary activities /2, and data processing. URSIT reflects changes in the industry and regulatory policies. Also, the language and tone of the rating definitions now conforms in each of the ratings systems.

As with the 1997 update of the CAMELS rating system, and the 1998 update of the fiduciary activities rating system, URSIT emphasizes the quality of risk-management processes. Two new component categories - Development and Acquisition, and Support and Delivery - replace the former Systems Development and Programming, and Operations components. The other components remain: Audit and Management. A composite rating is also assigned under URSIT and reflects the overall condition of an institution's or service provider's information technology function. The composite rating defines the level of regulatory attention required.

We anticipate implementing this new rating system during the second quarter. The FDIC will utilize URSIT in information systems examinations started on or after April 1. The Federal Reserve has not announced its implementation date.

1/ Uniform Financial Institutions Rating System effective January 1, 1997
2/ Uniform Interagency Trust Rating System effective January 1, 1999

YEAR 2000 (continued from page 2)

plans to meet customer needs throughout the geographical service area. When a financial institution uses a third party to service its cash disbursement requirements, it should review the third party provider's plan to ensure these services and facilities can provide sufficient cash to meet customer needs in late 1999 and early 2000.

A financial institution may need to review its insurance coverage and security processes if it plans to hold additional cash reserves.

Institutions may minimize the impact of deposit outflows and cash withdrawals by customers through customer awareness. Throughout 1999, communicate with customers regarding Year 2000 efforts. Institutions should be prepared and prepare the staff to provide complete and accurate responses to questions and concerns raised by customers, keeping in mind that regulatory ratings of these efforts are confidential. As mentioned previously, there should be a plan for how the institution will respond to its customers should Year 2000 disruptions occur, whether caused by internal problems or external events.

The financial institution is in the best position to communicate with its customers. Distributing informational brochures and other disclosures in monthly or quarterly statements, establishing toll-free hotlines for customer inquiries, holding educational seminars, and developing Year 2000 Internet sites are some examples of communication vehicles.

Need more info? All Year 2000 information issued by the regulatory agencies is available from the Federal Financial Institutions Examination Council's website at www.ffiec.gov. If you do not have internet access, you may contact Ms. Hicks, Deputy Commissioner John Crockett's secretary, at (804) 371-9704 and she will help you.

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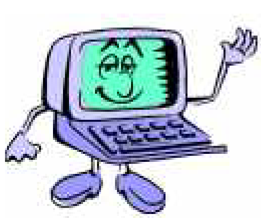

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