

**Department of Financial Institutions
For the Years Ended
June 30, 1999, and June 30, 1998**

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John G. Morgan
Comptroller

November 28, 2000

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Bill C. Houston, Commissioner
Department of Financial Institutions
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Financial Institutions for the years ended June 30, 1999, and June 30, 1998.

We conducted our audit in accordance with generally accepted government auditing standards. These standards require that we obtain an understanding of management controls relevant to the audit and that we design the audit to provide reasonable assurance of the Department of Financial Institutions' compliance with the provisions of policies, procedures, laws, and regulations significant to the audit. Management of the Department of Financial Institutions is responsible for establishing and maintaining internal control and for complying with applicable laws and regulations.

Our audit disclosed certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the department's internal control and/or instances of noncompliance to the Department of Financial Institutions' management in a separate letter.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/mb
00/061

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Financial Institutions
For the Years Ended June 30, 1999, and June 30, 1998

AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 1997, through June 30, 1999. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, payroll and personnel, external examinations, equipment, and compliance with the Financial Integrity Act. The audit was conducted in accordance with generally accepted government auditing standards.

AUDIT FINDINGS

The Department of Financial Institutions Has Not Fully Complied With Departmental Policies and Procedures and Federal Deposit Insurance Corporation Examinations Policies

The department's working papers did not adequately document procedures performed in support of bank reports of examination (page 6).

The Department's Practices Regarding Conflicts of Interest May Not Comply With State Law

The department's ethics practices apparently conflict with requirements of state law concerning indirect ownership of financial institutions' stocks (page 9).

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of Financial Institutions
For the Years Ended June 30, 1999, and June 30, 1998

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Department of Financial Institutions
For the Years Ended June 30, 1999, and June 30, 1998

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Financial Institutions. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

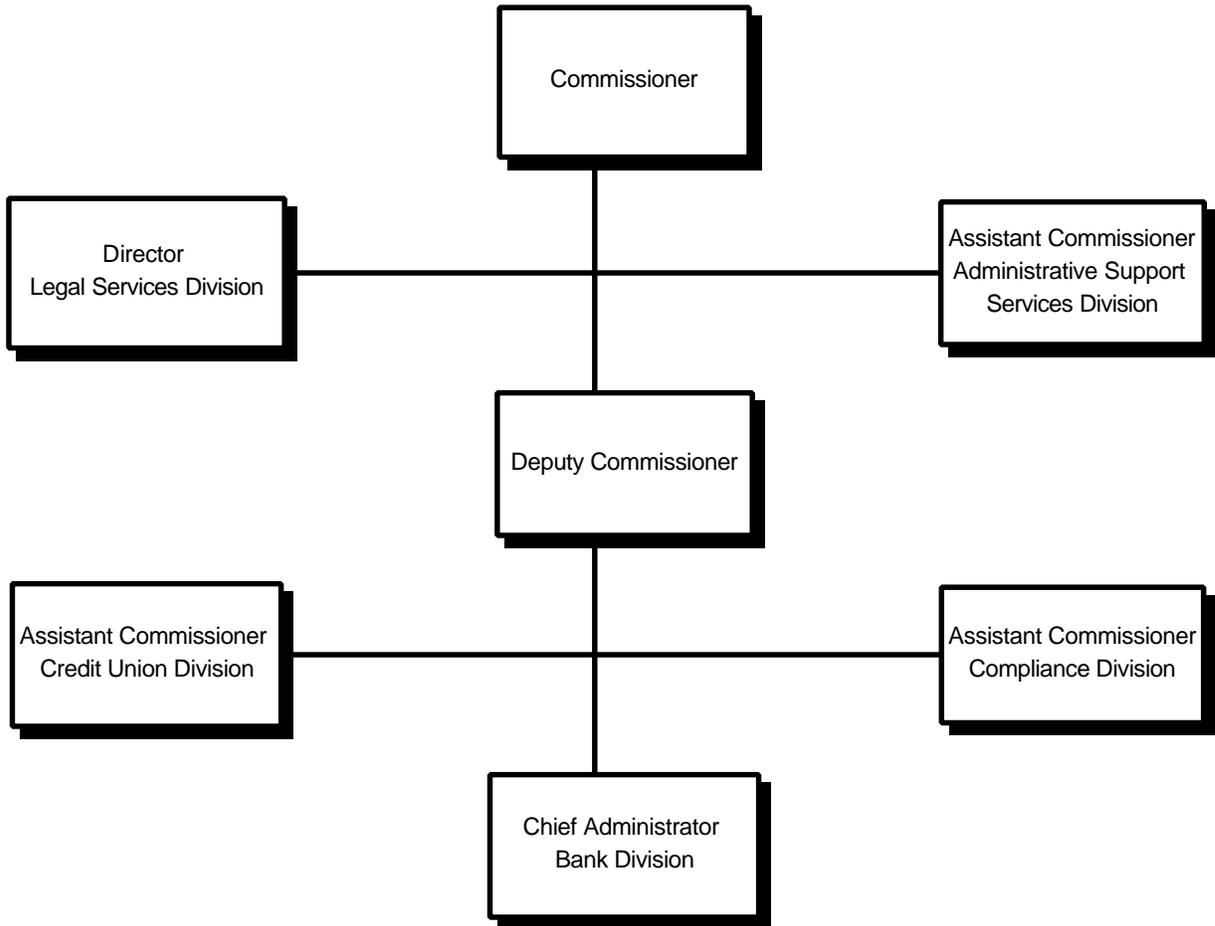
BACKGROUND

The primary mission of the Department of Financial Institutions is to provide the citizens of Tennessee with a sound system of state-chartered financial institutions. The Bank Division is responsible for the regulation and supervision of state-chartered financial institutions such as state-chartered banks, savings banks, savings and loan associations, credit card banks (banks which only engage in credit card operations), and business and industrial development corporations (BIDCOs). The Credit Union Division is responsible for the regulation and supervision of state-chartered credit unions. The Compliance Division is responsible for regulatory oversight activities such as licensing, examination, and complaint resolution for industrial loan and thrift companies; insurance premium finance companies; home mortgage servicing, lending, and brokering; money transmitters (money order issuers); and title pledge lending. On March 1, 1998, the Department of Financial Institutions became responsible for examining check cashing and check advance companies.

The Department of Financial Institutions attempts to encourage the development of depository financial institutions while restricting their activities to the extent necessary to safeguard the interests of depositors. The department also works to ensure that both depository and non-depository financial institutions comply with governing laws and regulations.

An organization chart of the department is on the following page.

Department of Financial Institutions Organization Chart



AUDIT SCOPE

We have audited the Department of Financial Institutions for the period July 1, 1997, through June 30, 1999. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of revenue, expenditures, equipment, payroll and personnel, external examinations, and compliance with the Financial Integrity Act. The audit was conducted in accordance with generally accepted government auditing standards.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

REVENUE

Our objectives in reviewing revenue transactions were to determine whether

- revenue transactions appear accurate and valid
- cash collected during the fiscal year was deposited timely and accounted for in the appropriate fiscal year, and
- fees had been billed or changed and recorded at the correct amount.

We discussed collection and receipt controls and procedures with key management personnel to gain an understanding of the department's procedures over these areas. We reviewed supporting documentation and tested a sample of transactions that were deposited during the audit period by tracing deposits through the receipting process to determine whether controls were adequate and records were complete.

We had no findings related to revenue; however, a minor weakness came to our attention, which has been reported to management in a separate letter.

EXPENDITURES

Our objectives in reviewing expenditure transactions were to determine whether

- expenditures were for goods and services authorized and the goods and services were received,
- payments were made in a timely manner,
- records were reconciled with Department of Finance and Administration reports,
- payments for travel were made in accordance with the *Comprehensive Travel Regulations*, and
- funds encumbered were liquidated for the same purpose as the original encumbrance.

We discussed purchasing, receiving, disbursement, contract, and reconciliation controls and procedures with key management personnel to gain an understanding of the department's procedures over these areas. We reviewed supporting documentation and tested a sample of transactions to determine whether transactions were adequately supported and approved, invoices were mathematically correct, duplicate payment was precluded, discounts were taken, transactions were charged to the proper object code, sales tax was not paid, proper bidding procedures were followed, single-source purchases were properly approved, journal voucher transfers were proper, and invoices were not split.

We had no findings related to expenditures; however, other minor weaknesses came to our attention, which have been reported to management in a separate letter.

EQUIPMENT

Our objectives in reviewing equipment were to determine whether equipment

- is properly safeguarded,
- is properly recorded on the property listing, and
- can be located.

We discussed controls and procedures over equipment with key management personnel to gain an understanding of the department's procedures over these areas. We tested a sample of equipment on the property listing to ensure that the information on the listing agreed with the actual item. We traced a sample of equipment located in the offices to the property listing to ensure that the items were properly recorded on the property listing.

We had no findings related to equipment; however, other minor weaknesses came to our attention, which have been reported to management in a separate letter.

PAYROLL AND PERSONNEL

Our objectives in reviewing payroll and personnel were to determine whether

- payroll disbursements were made only for work authorized and performed;
- payroll is recorded correctly, distributed properly, and computed using rates in accordance with contracts, laws, and regulations;
- employees are qualified for their positions; and
- performance evaluations are completed timely.

We discussed controls and procedures over payroll and personnel with key management personnel to gain an understanding of the department's procedures over the areas.

We had no findings related to payroll and personnel; however, other minor weaknesses came to our attention, which have been reported to management in a separate letter.

EXTERNAL EXAMINATIONS

Our objectives in reviewing external examinations were to determine whether

- the agency is properly planning, documenting, reviewing, and reporting its examination assignments;
- the agency's examiners are properly qualified for their positions; and
- the agency's examiners are properly supervised.

We discussed controls and procedures over external examinations with key management personnel to gain an understanding of the department's procedures over these areas. We tested a sample of examinations of banks, trust companies, credit unions, industrial loan and thrift companies, and premium finance companies to determine whether the department has performed the examinations in accordance with applicable policies, rules, and regulations. We also performed testwork to determine whether the examiners were qualified.

The audit revealed that examination work papers did not always contain documentation sufficient to support report conclusions. Also, the department's practices regarding conflicts of interest may not comply with state law.

In addition to these findings, other minor weaknesses came to our attention, which have been reported to management in a separate letter.

1. The Department of Financial Institutions has not fully complied with departmental policies and procedures and Federal Deposit Insurance Corporation examinations policies

Finding

The Department of Financial Institutions has not fully complied with its policies and procedures for bank examination documentation or with the Federal Deposit Insurance Corporation's (FDIC) *Division of Supervision (DOS) Manual of Examination Policies*. The department has a cooperative agreement with FDIC whereby both the department and FDIC agree to participate in the Cooperative Examination Program to examine state-chartered insured financial institutions. This agreement allows the department to rely on federal examination reports and the FDIC to rely on the department's examination reports on an alternating basis. In addition, the department has an Alternate Examination Agreement with the Federal Reserve Banks of Atlanta and Saint Louis to examine state-chartered banks that are also members of the Federal Reserve. This agreement also allows the department to rely on federal examination reports in place of the department's and the Federal Reserve to rely on the department's examination reports on an alternating basis.

Although federal regulators rely on the department's examination reports, the department has not met the documentation standards described in the FDIC *DOS Manual*. Federal standards for adequacy of documentation are found in FDIC *DOS Manual* Section XII *Examination Workpapers*:

All procedures performed during the examination should be sufficiently documented in the workpapers. . . .

This documentation should be prepared and retained in the workpapers for all job assignments regardless of whether the assignment involved an examination report page or a disclosed problem. The workpapers for each assignment should include a brief summary of the procedures performed and the basis for the conclusion reached.

A sample of 25 examinations was randomly selected from the three district field offices.

- Seven of the 25 examinations (28%) did not meet the department's Bank Division policy requirements or FDIC standards for documentation. The workpapers did not meet the FDIC and department standard requiring working papers provide adequate documentation to show procedures in support of the report of examination conclusions.

For example, the workpapers did not contain schedules to show the examiner's determination of account balances and adjustments. The only contents of most of the workpaper folders were documents provided by bank management such as financial information, board minutes, and policies.

The auditors, with the assistance of Financial Institution personnel, attempted to reperform procedures to determine if conclusions were reasonable. It was not possible for auditors to reperform some procedures because workpapers lacked documentation necessary to substantiate how the examiners reached their conclusions.

An example of this lack of procedural and basis documentation is the review of bank loan and investment policies. The files contained only copies of the policies; no notes or other documentation were available to show that the review was actually performed. Without written documentation, it is difficult to determine what basis an examiner originally used to reach a conclusion. Frequently, the auditors had to make inquiry of the Financial Institution personnel to determine the reasonableness of conclusions, and Financial Institution's personnel were unable to substantiate conclusions from the information in the workpapers. The auditors were told that essentially the conclusion was based on the examiner's judgment, and it was too time-consuming to document the bases for these conclusions. These seven examinations were all from the Middle Tennessee District Field Office.

- Two of 25 examinations (12%) did not support assertions made in the bank examination report. One report page contained an account balance based on an adjustment that was not documented. Neither the District Manager nor the Examiner In-charge was able to explain the source of the adjustment. On the same report page, a balance did not agree with the amount reported by the bank on the FDIC Universal Bank Performance Report, and there was no adjustment associated with the balance. In a different examination, information concerning the date of adoption of an investment policy was misreported. Both of these examinations were from the Middle Tennessee District Field Office.

Not adequately documenting the procedures and bases for conclusions in the reports of examination prevents the department from meeting FDIC standards for adequacy of documentation. Adequate working paper documentation would also allow for improved review and for improved support of report conclusions and recommendations.

Recommendation

The Commissioner should ensure that departmental policies and FDIC standards are followed in the documentation of examinations. In addition, the Commissioner should ensure a quality control process is put into place to ensure examination reports and workpapers meet the required standards.

Management's Comment

We concur that the department has not fully complied with its policies and procedures for bank examination documentation or with the FDIC's Division of Supervisor's Manual of Examination Policies as it relates to the maintenance of examination workpapers in the Middle Tennessee District Field Office.

As reported by the auditors, the department has entered into cooperative alternating examination agreements with both the FDIC and the Federal Reserve. These agreements allow the department to rely on federal examination reports in place of ours and let the federal regulatory agencies rely on the department's examination reports in place of theirs on an alternating basis.

With regard to the examination workpapers, it has been, and continues to be, the policy of the department to require that the workpapers fully support the conclusions and assertions contained in the bank examination reports. In fact, based upon the findings and recommendations from prior period audits, significant steps have been taken to enhance the maintenance and integrity of both the examination workpapers and examination report. These actions have included the development of a standardized examination work program to promote uniformity and consistency statewide; enhanced review procedures and documentation thereof; development of an examiner independence statement to identify potential conflict of interests; enhanced preplanning procedures; and the development of an indexing and labeling system for workpapers. Despite these efforts, the department acknowledges that weaknesses continue to exist in the quality of examination workpapers, especially in the Middle Tennessee District Field Office. However, it is our strong opinion that these reported deficiencies are isolated instances, and represent the exception rather than the norm, since no deficiencies were identified in either the West Tennessee or East Tennessee District Field Office. In conclusion, management asserts that immediate action will be initiated to correct the identified deficiencies, thereby further enhancing the integrity of examination workpapers by the following means:

- 1) Reemphasize to bank division management and examiner staff the importance of following departmental policy;
- 2) Reemphasize the importance that workpapers fully support the conclusions and assertions reported in bank examination reports; and
- 3) A more active role by upper level management in ensuring that all appropriate documents and documentation are maintained in the field workpapers.

2. The department's practices regarding conflicts of interest may not comply with state law

Finding

The Department of Financial Institutions' practices concerning conflicts of interest apparently conflicts with *Tennessee Code Annotated 45-1-117, Banking interests of employees of department*. *Tennessee Code Annotated 45-1-117(b)* states,

The commissioner, or any other employee of the department, shall not hold office or position in, have any indirect pecuniary interest in, or directly or indirectly own shares or securities issued by an institution supervised by the department, except that the commissioner may continue to own shares or securities issued by an institution which are owned on the date of the commissioner's appointment and all shares or security distributed by the institution and received by the commissioner on account of the shares or securities so owned. . . .

The conflict of interest forms for a sample of bank, credit union, and compliance examiners-in-charge were reviewed. Two of the examiners-in-charge had an indirect pecuniary interest in stock of an institution supervised by the department in that their spouses owned the stock. As a result of the sample, the employee disclosure forms of all persons in management positions were reviewed. This review found that the spouse of one other person in management owned stock of an institution supervised by the department.

Tennessee Code Annotated 45-1-107(a) states,

In addition to other powers conferred by this title, the commissioner has the power to: (1) Interpret the provisions of this chapter and chapter 2 of this title, and regulate banking practices thereunder;

Under the provisions of this statute, the Commissioner of the Department of Financial Institutions has deemed that the employees mentioned above are not in violation of state law. Although the Commissioner has discretion in interpreting section 45-1-117(b), it would appear that his interpretation would be inconsistent with the statute.

Recommendation

The department should seek clarification through legislation to eliminate an apparent lack of compliance with TCA 45-1-117(b) and a clarification as to the extent of the Commissioner's ability to interpret the provisions of Title 45, Chapters 1 and 2.

Management's Comment

We do not concur that the department's practices may not comply with state law.

As pointed out in your comments, the point at issue here is not really the practices of the department. The real issue is whether the Commissioner's interpretation of TCA Section 45-1-117(b) is consistent with what the legislature intended when the statute was adopted in 1969. You appear to agree that the three instances referenced in your comments were properly reported to the department, the investments are permissible under the department's ethics policy, and that the ethics policy has been approved by the Commissioner.

TCA Section 45-1-117(b) provides, among other things, that no employee may directly or indirectly own shares or securities issued by an institution supervised by the department. It does not specifically reference ownership by an employee's spouse or other family member. Thus, the legislature has provided no clear direction as to how spousal ownership of shares should be handled. It has, however, provided the Commissioner with the power to interpret the provisions of the Banking Act of which TCA Section 45-1-117(b) is a part.

We believe it is generally understood that marriage does not automatically confer an indirect ownership of the husband in the wife's personally held assets and vice versa. We agree that there are circumstances when this may be the case and our ethics policy actually precludes spousal ownership of stock in regulated institutions except under certain circumstances where the employee is obviously not in control. For instance, our ethics policy permits spousal ownership where it existed prior to the employee's employment with the department, as a result of a change in marital status, or through inheritance, gift, merger, or a change in corporate ownership of a company. In any such instance, however, the employee is required to report the spouse's ownership and is disqualified from participation in any decision relative to that regulated entity. This is similar to provisions contained in the ethics policies of other federal and state regulators. Further, we believe it is fully sufficient to prohibit conflicts of interest (or even the appearance of a conflict), and is consistent with Tennessee law.

The department has extensively researched the law, case law, Attorney General Opinions, and the issues addressed in our detailed ethics policy, including the issue of indirect pecuniary interest. Because of that research we are confident that our ethics policy is consistent both with TCA Section 45-1-117(b) and with the intent of the legislature in enacting Section 45-1-117(b). We further believe that our ethics policy is an appropriate function of the Commissioner in interpreting the provisions of the Act as authorized by TCA Section 45-1-107(a)(2).

Additionally, the department has engaged in several discussions with the Comptroller's office. To date we have not been provided with your basis to support that a finding concerning an indirect pecuniary interest would be appropriate under the fact circumstances which exist under the three examples cited. In each instance cited by you, ownership is under the sole control of the spouse including any dividends that are paid or reinvested. Further, under our ethics

policy, in such an instance the employee whose spouse has an interest in an institution is disqualified from any dealings with that institution, thus avoiding any conflict of interest.

The department believes very strongly that ethical behavior on the part of our employees is of the utmost importance in the performance of our duties. The adoption of our ethics policy on January 1, 1998 was an attempt to provide clear guidance to our employees in this regard. It is a fifteen-page document covering not only stock ownership, but many other situations as well. When TCA Section 45-1-117 was adopted in 1969, this department regulated only banks, credit unions and money order issuers. Since that time, numerous other industries have been placed under our regulation. In addition, the financial institutions industries have undergone massive changes such as interstate branching and the creation of financial conglomerates under a single charter. This has added to the complexities of assuring that ethical standards are observed and was the primary reason for the adoption of our ethics policy in 1998.

As we advised your auditors during their visit, we are also discussing with the administration the need to make several changes to the Banking Act, including some in TCA Section 45-1-117. If approved by the administration, we will fully discuss with the legislature the concerns you have expressed in this finding, even though we strongly feel that we are presently in full compliance with state law.

Rebuttal

Although the Commissioner has discretion in interpreting TCA Section 45-1-117(b), his interpretation must be consistent with the statute. The statute contains an express prohibition of both direct and indirect interest as evidenced by the phrase “shall not . . . have any indirect pecuniary interest in . . . shares or securities.” The department’s position that marriage does not automatically confer indirect ownership may have some validity. However, in other cases, the Tennessee Attorney General’s office has held that an employee has an indirect interest if that employee commingles assets with his/her spouse or other relative. Our position concerning this matter and the basis to support the finding have been discussed with the department’s management, its legal counsel, and the Tennessee Attorney General’s office. While it is true that the department’s employees disclosed the spousal ownership of stock, and the department addressed the matter, the statute does not provide for a disclosure exception allowing an employee to have an indirect pecuniary interest in shares or securities issued by institutions supervised by the department.

FINANCIAL INTEGRITY ACT

The Financial Integrity Act of 1983 requires each executive agency to annually evaluate its systems of internal accounting and administrative control and report the results of its evaluation to the Commissioner of Finance and Administration and the Comptroller of the Treasury by December 31 of each year.

The objectives of our review of the department's compliance with the Financial Integrity Act were to determine whether

- the agency's reports were filled in compliance with the Financial Integrity Act of 1983,
- documentation to support the agency's evaluation was properly maintained,
- procedures used in compiling information for the reports were adequate, and
- corrective actions have been implemented for weaknesses identified in the reports.

We interviewed key employees responsible for compiling information for the reports to gain an understanding of the procedures. We also reviewed the supporting documentation for these procedures and the reports submitted to the Comptroller of the Treasury and to the Department of Finance and Administration.

We determined that the Financial Integrity Act reports were submitted on time, and support for the reports was adequate.

PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

APPENDIX

ALLOTMENT CODE

The Department of Financial Institutions' allotment code is 336.00.