

**Department of Financial Institutions**

**June 2002**

***Arthur A. Hayes, Jr., CPA, JD, CFE***  
Director

***Deborah V. Loveless, CPA***  
Assistant Director

***Diana L. Jones, CGFM***  
Audit Manager

***Joseph Schussler, CPA, CGFM***  
In-Charge Auditor

***Lamont Price***  
Staff Auditor

***Amy Brack***  
Editor

Comptroller of the Treasury, Division of State Audit  
1500 James K. Polk Building, Nashville, TN 37243-0264  
615-401-7897

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**STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY**

State Capitol  
Nashville, Tennessee 37243-0260  
(615) 741-2501

**John G. Morgan**  
Comptroller

June 26, 2002

The Honorable John S. Wilder  
Speaker of the Senate  
The Honorable Jimmy Naifeh  
Speaker of the House of Representatives  
The Honorable Thelma M. Harper, Chair  
Senate Committee on Government Operations  
The Honorable Mike Kernell, Chair  
House Committee on Government Operations  
and  
Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the performance audit of the Department of Financial Institutions. This audit was conducted pursuant to the requirements of Section 4-29-111, *Tennessee Code Annotated*, the Tennessee Governmental Entity Review Law.

This report is intended to aid the Joint Government Operations Committee in its review to determine whether the department should be continued, restructured, or terminated.

Sincerely,

John G. Morgan  
Comptroller of the Treasury

JGM/dlj  
02-010

State of Tennessee

# Audit Highlights

Comptroller of the Treasury

Division of State Audit

Performance Audit  
**Department of Financial Institutions**  
June 2002

## AUDIT OBJECTIVES

The objectives of the audit were to determine the department's legislative mandate and the extent to which it has carried out that mandate efficiently and effectively and to make recommendations that might result in more efficient and effective operation of the department.

## FINDING

### **The Department Has Failed to Produce an Annual Report in Accordance With Statute**

For at least the last five years, the department has not produced its annual report in accordance with statute or in a timely manner. *Tennessee Code Annotated* requires an annual report within 60 days of the fiscal year end; however, the department produces its annual reports based on the calendar year because that is how banks report their information. Information required to be in the annual report is not available until approximately three months after the end of the calendar year, and the annual report itself is not produced until several months later. For the last five years, the time from the end of the calendar year until the annual report was published has been eight months (1996), six months (1997), seven months (1998), and ten months (1999 and 2000) (page 9).

## OBSERVATIONS AND COMMENTS

Issues that did not warrant findings but are included in this report because of their effect or potential effect on the operations of the department and on the citizens of Tennessee include the need for the department to consider revising its method for calculating bank rebates, the increase in the number of troubled banks, and the department's review of Franklin American Trust Company's application (page 4).

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"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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# Performance Audit Department of Financial Institutions

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# **Performance Audit Department of Financial Institutions**

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## **INTRODUCTION**

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### **PURPOSE AND AUTHORITY FOR THE AUDIT**

This performance audit of the Tennessee Department of Financial Institutions was conducted pursuant to the Tennessee Governmental Entity Review Law, *Tennessee Code Annotated*, Title 4, Chapter 29. Under Section 4-29-224, the department is scheduled to terminate June 30, 2003. The Comptroller of the Treasury is authorized under Section 4-29-111 to conduct a limited program review audit of the department and to report to the Joint Government Operations Committee of the General Assembly. The performance audit is intended to aid the committee in determining whether the department should be continued, restructured, or terminated.

### **OBJECTIVES OF THE AUDIT**

The objectives of the audit were

1. to determine the authority and responsibility mandated to the department by the General Assembly,
2. to determine the extent to which the department has met the legislative mandate,
3. to evaluate the efficiency and effectiveness of the department, and
4. to recommend possible alternatives for legislative or administrative action that may result in more efficient and effective operation of the department.

### **SCOPE AND METHODOLOGY OF THE AUDIT**

The audit reviewed the activities of the department from July to November 2001. The audit was conducted in accordance with government auditing standards generally accepted in the United States of America and included

1. review of applicable legislation and department policies and procedures;
2. contact with representatives of the Tennessee Bankers Association and the Conference of State Bank Supervisors;

3. interviews with department staff; and
4. examination of the department's records, files, and reports.

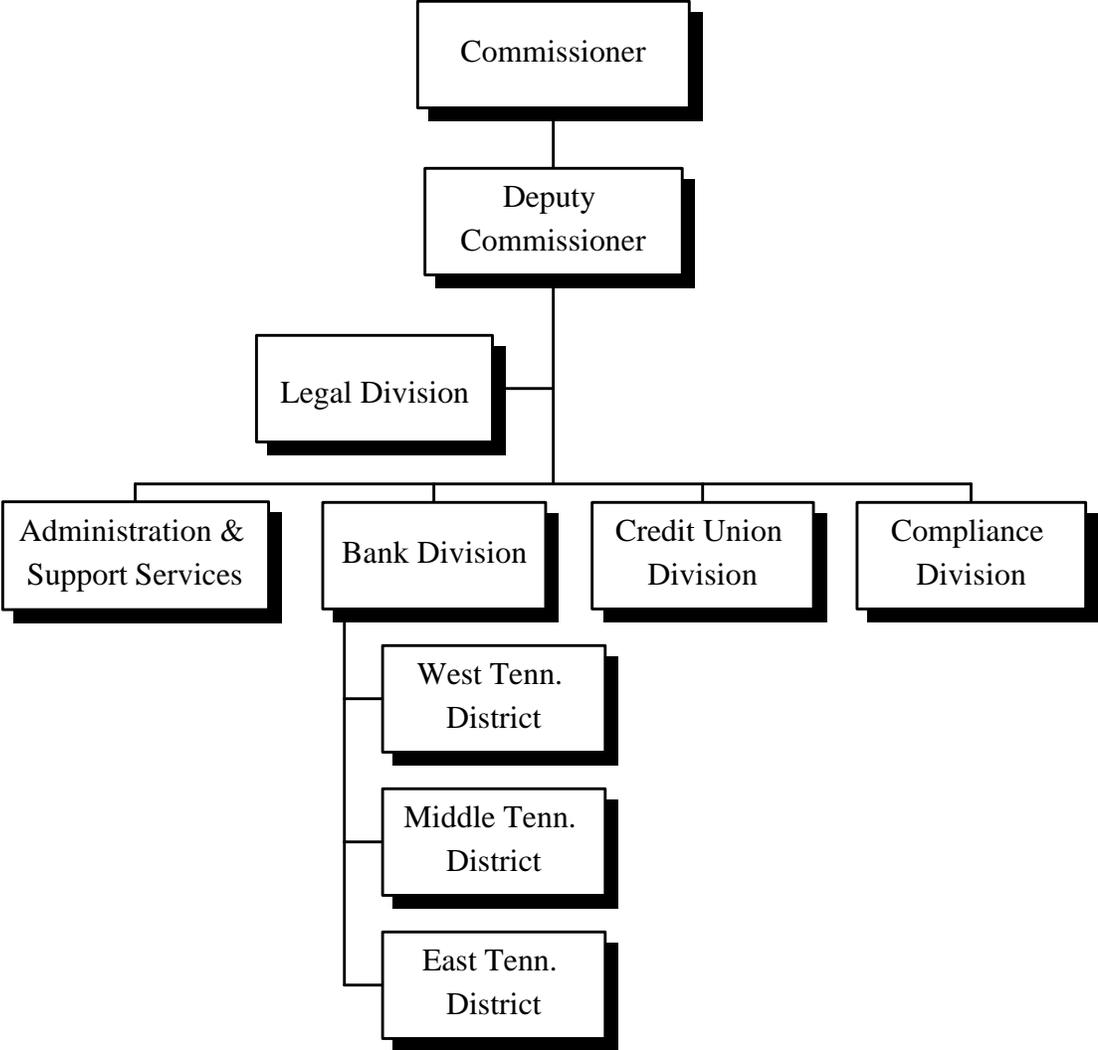
## **ORGANIZATION AND RESPONSIBILITIES**

In 1983, the Department of Financial Institutions replaced the Department of Banking, which had separated from the Department of Insurance and Banking in 1973. The Department of Financial Institutions' mission is "to provide the citizens of Tennessee with a sound system of state-chartered financial institutions." The department does this by regulation and examination of all state-chartered banks, credit unions, and trust institutions, and by oversight of industrial loan and thrift companies, home mortgage companies, and other finance-related agencies.

Under the commissioner, the department has four divisions: Administration and Support Services, Bank, Credit Union, and Compliance. The Administration and Support Services Division contains Human Resources, Training, Fiscal Services, and Information Management. The Bank Division regulates and supervises Tennessee's state-chartered banking system by granting charters, conducting periodic examinations, and monitoring financial data. The Credit Union Division performs a similar function for state-chartered credit unions by examining and monitoring that industry. The Compliance Division licenses and regulates seven types of financial institutions: check cashing, deferred presentment, money transmitters, industrial loan and thrift companies, insurance premium finance companies, residential mortgage lenders, and residential mortgage brokers. (See the organization chart on page 3.)

At December 31, 2000, the department oversaw 169 banks, 13 independent non-depository trust companies, 149 credit unions, and 3,329 licensees through the Compliance Division. For fiscal year 2001, the department had revenue of \$8,366,960 and expenditures of \$7,753,522 and had 110 employees at fiscal year end.

**Department of Financial Institutions  
Organization Chart  
June 2002**



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## OBSERVATIONS AND COMMENTS

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The issues discussed below did not warrant findings but are included in this report because of their effect or potential effect on operations of the department and on the citizens of Tennessee.

### **THE DEPARTMENT SHOULD CONSIDER REVISING ITS METHOD FOR CALCULATING BANK REBATES**

The department, which is funded entirely by fees from regulated entities, is required by statute to charge the regulatory costs of each division to the institutions regulated. In recent years, the department has developed a system of cost centers to determine the extent to which fees collected for each type of institution cover the cost of regulating those institutions. However, when calculating the amount it refunds to banks each year, the department continues to use the same method of calculation it used prior to the improvements in its ability to track expenditures. As a result, the department annually rebates more in bank fees than it should, given the cost of bank regulation. For fiscal years 1998 through 2001, the total amount rebated in excess was more than \$700,000.

The department is divided into four divisions to track revenue and expenditures. Only the Bank, Credit Union, and Compliance divisions receive revenue; the expenditures of the Commissioner, Administration, and Legal division are allocated to the other three divisions. Only the banks, however, are statutorily required to receive a refund if revenues exceed expenditures; there is no refund requirement in the statute sections for regulation of credit unions or the other financial agencies. Section 45-1-118(d)(2), *Tennessee Code Annotated*, states, “Any funds collected by the department but unexpended at the end of a fiscal year shall not revert or in any way be transferred to the general fund but shall be rebated to the state banks, within one hundred eighty (180) days, or shall be credited against the banking fee owed by the state banks for the current fiscal year.”

For fiscal years 1998 through 2001, the banks paid less in fees than the cost of regulation, which appears to violate statute. This situation occurs because, rather than simply refunding the surplus of revenues over expenditures, the department calculates the percent of revenue provided by bank assessments and applies this percentage to the total department surplus. For example, for fiscal year 2001, the bank division had a surplus of \$291,913, but the department refunded \$337,391 to the banks (see table on page 5), effectively returning part of the surplus from the other divisions. Over the last four years, the total amount refunded exceeded the total bank surplus by \$746,240. Because the department can now accurately segregate revenues and expenditures by division, the actual amount of surplus bank fees is known. It seems appropriate that the department refund banks the amount of the surplus and no more.

## Summary of Bank Rebate Calculations

	Fiscal Year 1998	Fiscal Year 1999	Fiscal Year 2000	Fiscal Year 2001
<b>Bank Division</b>				
Revenue	\$5,424,288	\$4,897,782	\$4,764,239	\$4,915,091
Expenditures	4,524,435	4,661,557	4,745,145	4,623,178
Surplus	\$ 899,853	\$ 236,225	\$ 19,094	\$ 291,913
<b>Credit Union Division</b>				
Revenue	\$1,205,031	\$1,261,863	\$1,353,259	\$1,377,280
Expenditures	1,092,037	1,160,100	1,210,142	1,354,461
Surplus	\$ 112,994	\$ 101,763	\$ 143,117	\$ 22,819
<b>Compliance Division</b>				
Revenue	\$1,612,237	\$1,893,945	\$1,862,478	\$2,074,589
Expenditures	1,135,968	1,305,856	1,315,642	1,775,883
Surplus	\$ 476,269	\$ 588,089	\$ 546,836	\$ 298,706
<b>Department Total</b>				
Total revenue	\$8,241,556	\$8,053,590	\$7,979,976	\$8,366,960
Total expenditures	6,752,440	7,127,513	7,270,929	7,753,522
Surplus	\$1,489,116	\$ 926,077	\$ 709,047	\$ 613,438
<b>Rebate paid to banks</b>				
	\$ 923,914	\$ 527,864	\$ 404,156	\$ 337,391
<b>Bank Division surplus</b>				
	\$ 899,853	\$ 236,225	\$ 19,094	\$ 291,913
<b>Excess of rebate as compared to surplus</b>				
	\$ 24,061	\$ 291,639	\$ 385,062	\$ 45,478

The Department of Financial Institutions should consider revising the method it uses to calculate the bank rebate so that the rebate equals the surplus of bank revenues over expenditures.

### Department of Financial Institutions' Comment

The department is in the process of modifying the bank rebate method to utilize the bank division's cost center information in determining the amount of surplus to rebate to state banks. The surplus will be calculated from revenue coming into the bank division less the expenses reflected from the cost center, but there will have to be an adjustment for non-bank money collected. Fees from state chartered business and industrial development corporations and trust companies will be subtracted from the calculation. The statute provides no specific guidance as to how the rebate should be calculated. While the department believes that the rebate calculation

which was developed before the cost center system had been fully established is reasonable, we also believe that utilizing the cost center information will be helpful to this process.

### **INCREASE IN THE NUMBER OF TROUBLED BANKS**

A bank examination includes an evaluation of five performance indicators: capital adequacy, asset quality, management, earnings, and liquidity. The resulting score is referred to as the CAMEL rating and ranges from 1 (highest) to 5 (lowest). A bank with a score of 3, 4, or 5 is “troubled” and requires corrective action to improve its rating to a 1 or 2. Since the time of the previous performance audit (1994), the number of troubled banks decreased to 2 in 1997 but increased to 9 in 1998, 16 in 1999, 18 in 2000, and 27 as of September 2001. According to department management, the economy is a major factor in the condition of the local banking system so department efforts to improve the situation may have limited effectiveness. However, the department is addressing the number of troubled banks by intentionally increasing visits to monitor banks, assessing banks for the cost of additional monitoring work related to a troubled rating, and meeting with management of banks not yet troubled but with evidence of heading in that direction.

### **DEPARTMENT REVIEW OF THE APPLICATION OF FRANKLIN AMERICAN TRUST COMPANY**

In 1999, a fraudulent insurance investment operation was exposed involving several Tennessee business entities. Subsequent state and federal investigations identified weaknesses in key insurance regulatory activities. Because a trust company regulated by the Department of Financial Institutions was associated with several of the entities involved in the operation, we reviewed the department’s activities in approving that trust company’s application for a charter. Our analysis indicated that, although the department followed its typical review procedures prior to granting the charter, it did not use all the resources available to help it identify problems or potential problems with the applicant or its related organizations. In addition, the review raised questions about the extent to which the department should expand its investigations to include related businesses and their officials.

In November 1997, the Franklin American Trust filed an application with the Tennessee Department of Financial Institutions, seeking a bank charter to become a nondepository trust company in Tennessee. According to the application, the company was being formed by Franklin American Corporation, a publicly traded Tennessee corporation. The department approved the application in August 1998, and a certificate of authority was issued to Franklin American Trust on October 30, 1998.

On May 11, 1999, the Davidson County Chancery Court entered a consent order appointing the Commissioner of the Tennessee Department of Commerce and Insurance as receiver for the purposes of rehabilitating Franklin American Life Insurance Company, a subsidiary of Franklin American Corporation. At the same time, Franklin American Corporation

ordered Franklin American Trust Company to self-liquidate. On May 12, 1999, the trust company (which according to department staff could not self-liquidate without the department's permission) contacted the Department of Financial Institutions and requested that the department issue an emergency Cease and Desist Order. The purpose of the request was to protect the company's assets from seizure in subsequent legal actions against Franklin American Corporation or any of its affiliates.

As soon as the department was contacted by the trust company, staff conducted an informal review and found that Franklin American Trust had invested approximately 20% of its assets (and approximately 60% of the assets it had under management) with Franklin American Corporation and its subsidiaries. In evaluating the appropriateness of the investments, the department used as a standard a Federal Reserve Board regulation which states, "(A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and (B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank." As a result of the review, the department immediately requested and was granted an emergency order directing the trust company "to cease and desist from engaging in unsafe and unsound banking practices." On August 13, 1999, the Department of Financial Institutions took possession of Franklin American Trust. The total amount of assets under management of the trust at that time was \$535,321. According to department staff, no account beneficiaries were negatively affected.

Our review of the Department of Financial Institutions' activities prior to granting Franklin American Trust Company's charter indicates that the department did take a variety of steps to review the appropriateness of the application. For example, staff reviewed the credit reports of trust company officials and any financial statements available from the applicant. In addition, staff contacted Department of Commerce and Insurance officials to discuss concerns about the structure of the trust. None of the review activities revealed any major areas of concern.

During its review, the department did not, however, take advantage of several information resources that might have led to questions about the trust company, particularly if the department had expanded its review to include related organizations and their officials. At the time the application was reviewed, the department was not linked (although access was available) to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCen) or the National Association of Securities Dealers' Central Registration Depository (CRD). (The department obtained access to FinCen during 1998 and to CRD after it was suggested by auditors during this audit.) In addition, the department did not obtain financial statements from Franklin American Life, the servicing company for Franklin American Trust.

Concerns about the application might have been raised if the department had used available information resources to investigate the backgrounds of the grantors for Thunor Trust. Franklin American Trust Company was linked in business to Thunor Trust, which was formed in 1991 "to purchase Franklin American Corporation and other related corporations." A check of

the Central Registration Depository would have revealed that an individual whose name appeared on the application as a grantor to Thunor Trust had been the subject of consumer complaints while working in the securities industry (which in Tennessee is regulated by the Department of Commerce and Insurance). The other two grantors listed on the application denied any knowledge of applying to be grantors for Thunor Trust when questioned by Department of Commerce and Insurance staff after the fraudulent insurance investment operation was discovered. In addition, a review of Franklin American Life Insurance Company's financial statements would have shown abnormally high growth and turnover rates in its securities for several years prior to 1998. (It should be noted, however, that the Department of Commerce and Insurance, which was responsible for reviewing these financial statements, did not have sufficient concerns to take significant actions against the company. For additional information regarding the Franklin American Life Insurance Company, see the Division of State Audit's July 2000 Special Report, *Department of Commerce and Insurance: Review of Inaction on the Part of Insurance Division Employees Involved in the Regulation of Franklin American Life Insurance Company.*)

The Department of Financial Institutions should revisit its application review process to ensure that the backgrounds of shareholders, owners, and others with influence over the financial decisions of an applicant are routinely investigated, checking relevant databases as part of the process. According to Applications Section staff, shortages of time and personnel limit the extent of the department's review of applications received. To help assist review staff, the department might consider cross-training other staff (e.g., support staff) to gather the information, which could then be evaluated by review staff. Department management should analyze costs and benefits and, based on that analysis, provide specific guidance concerning the extent to which (and under what circumstances) applicants' related organizations should be reviewed and the backgrounds of those organizations' officials investigated. In addition, the department should work closely and share information with the Department of Commerce and Insurance. This communication is particularly important since the 1999 passage of the Gramm-Leach-Bliley Act, which is intended to "enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers." It appears that the Department of Financial Institutions will increasingly need securities- and insurance-related information maintained by the Department of Commerce and Insurance in order to make decisions about the soundness of applicants and their affiliates.

#### Department of Financial Institutions' Comment

During the 2001 legislation session, the department recommended, and the General Assembly enacted, an amendment to the Banking Act to permit the department to share confidential bank regulatory information with the Department of Commerce and Insurance.

## TITLE VI INFORMATION

The Department of Financial Institutions does not receive any federal money or assistance and so does not fall under the jurisdiction of Title VI.

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## FINDING AND RECOMMENDATION

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### 1. The department has failed to produce an annual report in accordance with statute

#### Finding

For at least the last five years, the department has not produced its annual report in accordance with statute or in a timely manner. According to Section 45-1-119, *Tennessee Code Annotated*, the Department of Financial Institutions shall prepare within 60 days after the end of the fiscal year an annual report that includes

1. the text of all rules of the department of general application adopted or altered since the commissioner's last previous report;
2. recommendations for legislation;
3. a statement of the status and remaining assets and liabilities of all banking organizations in the possession of the commissioner;
4. a summary of all changes occurring since the commissioner's last previous report by reason of opening new state banks, mergers and conversions, increases and decreases in capital, and the like; and
5. a combined statement of condition of all state banks as of the date of the most recent reports of condition rendered to the commissioner, and reference to the availability in the commissioner's office of the statements of condition of each state bank, as of the date of the most recent reports to the commissioner.

According to management, the department produces its annual reports based on a calendar year because banks report their information on a calendar year. As a result, information required to be in the department annual report is not available until approximately three months after the end of the calendar year. The department annual report itself is not produced until several months after the information is received. For the last five years, the time from the end of the calendar year until the annual report is published has been eight months (1996), six months (1997), seven months (1998), and ten months (1999 and 2000). As an example, the 2000 annual report, statutorily required to be published by September 1, 2000, was dated December 31, 2000,

but was not published until October 2001, ten months later. The information in the report decreases in usefulness the later it is made available.

### **Recommendation**

The department should prepare the annual report based on a fiscal year and within 60 days of fiscal year end, as statute requires. Alternatively, it may request the statute be changed to base the report on a calendar year, to better coincide with the availability of information. In either case, the department should produce the report timely.

### **Management's Comment**

We concur with the finding. The department will report to the Governor annually within 60 days after the end of each fiscal year. The report shall address the five areas outlined in Section 45-1-119, *Tennessee Code Annotated*. We have not issued the annual report within 60 days after the end of the fiscal year because of our efforts to provide a comprehensive overview of the entire department beyond the statutory minimum. While we will issue the annual report as required by statute, the department will continue to provide access to all information that has historically been available in previous annual reports. We will also consider what changes, if any, need to be made in order to best inform the Governor, General Assembly, and the citizens of Tennessee about the regulation of financial institutions.

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## **RECOMMENDATION**

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### **ADMINISTRATIVE**

The Department of Financial Institutions should address the following area to improve the efficiency and effectiveness of its operations.

1. The department should prepare the annual report based on a fiscal year and within 60 days of fiscal year end, as statute requires. Alternatively, it may request the statute be changed to base the report on a calendar year, to better coincide with the availability of information. In either case, the department should produce the report timely.