PERFORMANCE AUDIT

Department of Financial Institutions
June 2012

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Comptroller of the Treasury

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Department of Audit
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June 21, 2012

The Honorable Ron Ramsey
 Speaker of the Senate
The Honorable Beth Harwell
 Speaker of the House of Representatives
The Honorable Mike Bell, Chair
 Senate Committee on Government Operations
The Honorable Jim Cobb, 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 of Financial Institutions should be continued, restructured, or terminated.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/dww
12-027

State of Tennessee

Audit Highlights

Comptroller of the Treasury Division of State Audit

Performance Audit
Department of Financial Institutions
June 2012

AUDIT OBJECTIVES

The objectives of the audit were to examine the system the department has established to address consumer complaints against financial institutions and review the department's process for notifying members of the public about their rights to file complaints; determine whether bank examinations are being conducted in a timely manner; and examine the department's system for securing sensitive financial information.

OBSERVATIONS AND COMMENTS

The audit report contains no findings but discusses the following issues: (1) consumer awareness of the department and its complaint process and (2) the length of time the department takes to process completed bank examinations (page 3).

Performance Audit
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INTRODUCTION

PURPOSE AND AUTHORITY FOR THE AUDIT

This performance audit of the Department of Financial Institutions was conducted pursuant to the Tennessee Governmental Entity Review Law, *Tennessee Code Annotated*, Title 4, Chapter 29. Under Section 4-29-234, the Department of Financial Institutions is scheduled to terminate June 30, 2013. The Comptroller of the Treasury is authorized under Section 4-29-111 to conduct a limited program review audit of the agency and to report to the Joint Government Operations Committee of the General Assembly. The audit is intended to aid the committee in determining whether the Department of Financial Institutions should be continued, restructured, or terminated.

OBJECTIVES OF THE AUDIT

The objectives of the audit were to

1. examine the system the department has established to address consumer complaints against financial institutions and review the department's process for notifying members of the public about their rights to file a complaint;
2. determine whether bank examinations are being conducted in a timely manner, and if not, ascertain what factors appear to be affecting the department's examinations efforts; and
3. examine the department's system for securing sensitive financial information.

SCOPE AND METHODOLOGY OF THE AUDIT

The activities of the Department of Financial Institutions were reviewed for the period January 2008 to December 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Methods used included

1. a review of applicable legislation and policies and procedures;

2. an examination of the entity's records, reports, and information summaries;
3. a review of prior performance audits and financial and compliance audit reports; and
4. interviews with department staff, staff of other state agencies, and non-profits, as well as with Federal Deposit Insurance Corporation officials who interact with the Department of Financial Institutions.

HISTORY AND STATUTORY 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, the Consumer Resources Section, the Legal Section, and Information Management. The Bank Division regulates and supervises Tennessee's money transmitters, Business and Industrial Development Corporations (BIDCOs), and the 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, examines, and regulates seven types of financial institutions:

- check cashing companies—persons who, for a fee, provide currency in exchange for a check or other payment instrument;
- deferred presentment, also known as payday lenders—persons who, for a fee, loan money in exchange for a post-dated check, and who agree not to present the check for payment for some period of time not to exceed 31 days;
- industrial loan and thrift companies—companies that typically make small-dollar, short-term loans, and that are authorized by law to charge higher interest rates and fees than generally allowed;
- insurance premium finance companies—companies that advance insurance premiums to an insurer on behalf of an insured, and for which the insured agrees to repay the amounts advanced, together with interest and a service charge;
- residential mortgage lenders—persons who make loans that are primarily for personal, family, or household use that are secured by residential real estate;
- residential mortgage brokers—persons who solicit, place, negotiate, or originate residential mortgage loans; and

- title pledge lenders—persons who, for interest and a fee, make 30-day non-recourse loans secured by motor vehicles or other titled personal property.

(See the department's organization chart on the following page.)

As of December 31, 2011, the department oversaw 155 banks, 9 independent non-depository trust companies, 100 credit unions, and 9,027 licensees. The department had 137 employees as of January 2012.

REVENUES AND EXPENDITURES

For fiscal year 2011, the department had actual expenditures for payroll and operations of $16,058,200 (100% generated from supervision, examination, and license fees assessed to those financial institutions regulated by the department). Estimated revenues and expenditures for fiscal year 2012 are $16,732,500.

OBSERVATIONS AND COMMENTS

The topics discussed below did not warrant a finding but are included in this report because of their potential effect on the operations of the Department of Financial Institutions and the citizens of Tennessee.

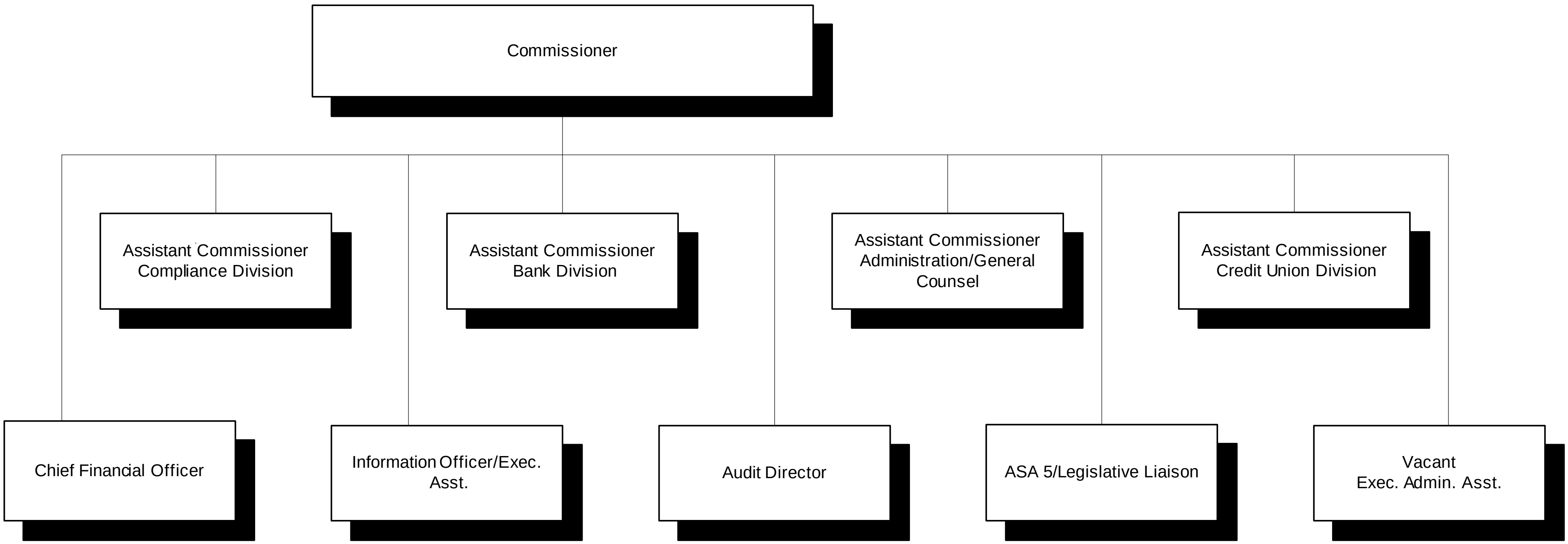
The Department of Financial Institutions Should Continue to Improve Consumer Awareness

The Department of Financial Institutions created the Consumer Resource Division (CRD) in March 2004 as a means of providing meaningful consumer protection and consumer education services statewide. The department is the only state agency that has the statutory jurisdiction to handle consumer concerns and complaints involving financial institutions operating under the various laws the department administers. A key responsibility of the division is the handling and tracking of consumer complaints. The division has an established structure for receiving, processing, and investigating complaints. Although the department has attempted to raise consumer awareness of the department and its functions, it may wish to consider what other methods it could use to increase awareness of the department's consumer protection services.

<u>Department of Financial Institutions Complaint Process</u>

The department regulates state chartered and licensed financial institutions. As part of its responsibilities, the Department of Financial Institutions responds to complaints filed by individuals who believe that they have been aggrieved by a financial institution. Staff with the Department of Commerce and Insurance's Division of Consumer Affairs and the Office of the Attorney General stated that they refer relevant complaints to the department. Loan modification

Department of Financial Institutions
Organization Chart



issues, repossession issues, nonsufficient funds charges, and balance discrepancies are examples of complaints received by the department.

In calendar year 2010, the Consumer Resource Division received a total of 515 formally filed complaints, and with the division's assistance, refunds totaling $125,585 were issued by entities that had complaints filed against them. According to department officials, consumers are made aware of the department and its Consumer Resource Division through word of mouth and through financial education services. The Consumer Resource Division has worked with high school teachers to prepare for newly required personal finance classes. The division has also participated in the LifeSmarts state competition through the University of Tennessee extension services. The department may wish to consider what it can do to increase consumer awareness of the department's complaint process. One option would be an improved disclosure system that expands the process that title pledge lenders use to disclose department contact information. For example, under the title pledge act, licensees are required to include the name and address of the department and a telephone number to which consumers may address complaints. Under the Tennessee Home Loan Protection Act (applicable only to high-cost home loans), the department must be included as a resource for a list of credit counselors. Another option would be to ask entities to post a sign visible to consumers that provides department contact information for submitting a complaint or, if applicable, for entities to have similar information on their websites. See the table below for a full list of entities regulated by the Department of Financial Institutions.

Table 1
Entities Regulated by the Department of Financial Institutions

Type of Entity	Number of Licensees
State-Chartered Banks	155
State-Chartered Credit Unions	100
Trust Companies	9
Business and Industrial Development Corporations (BIDCO)	2
Industrial Loan and Thrift Companies (TILT)	1,053
Mortgage Companies	460
Mortgage Branches	662
Mortgage Loan Originators	4,063
Title Pledge Lenders	834
Check Cashers	693
Deferred Presentment Services Companies	1,208
Money Transmitters	64
Insurance Premium Finance Companies	54

The Department of Financial Institutions can improve its website through enhancing the accessibility of the online complaint form. The department should include the online submission form in the same listing with the paper complaint form. With the online submission form more accessible, citizens and consumers will be able to better access the form and submit their complaints.

Comment by the Commissioner of the Department of Financial Institutions

With respect to the observation that the department should try to improve consumer awareness, we certainly agree and strive for continued improvement. Awareness of the Consumer Resources Section and the availability for consumers to register complaints against the department's regulated institutions is facilitated in a number of ways. Information about the consumer complaint process and the opportunity for complainants to file their complaint online via the link to the form on the department's website is provided on phone calls received in the Consumer Resources Section. While we do not rely on word-of-mouth methods, we do believe that "word of mouth" via consumers and/or legislative constituents who have received assistance through the use of the consumer complaint mechanism is evident. Additionally, the consumer complaint process is discussed from time to time in speaking engagements I have around the state, along with financial education presentations made by staff members of the Consumer Resources Section. As a board member of the Tennessee Financial Literacy Commission, I also have an opportunity to support consumer awareness.

The Department of Financial Institutions Is Attempting to Shorten the Length of Time It Takes to Process Completed Bank Examinations

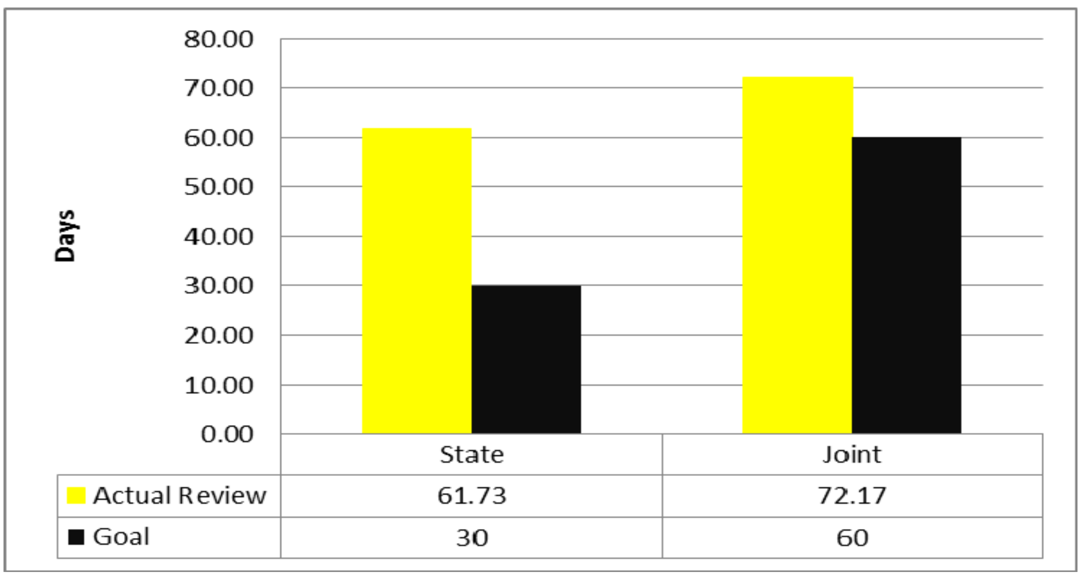
To ensure the soundness of the state's financial system, the Department of Financial Institutions performs examinations of state chartered banks, savings banks, and independent non-depository trust companies. Examinations are conducted by state examiners, federal examiners, or both (joint examinations). Federal and state bank examiners look at the same items when conducting an examination. The Department of Financial Institutions typically reviews all Reports of Examination conducted solely by a federal regulatory agency after the Report of Examination has been issued. The examiners submit the results of completed examinations and corresponding recommendations to address identified issues to officials of the bank being examined.

Financial institutions are rated on Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk (CAMELS) with a rating range of 1 to 5, with 1 being the best and 5 the worst. Joint examinations are conducted when a bank receives a CAMELS rating of 3, 4, or 5 or if the institution has over $1 billion in total assets. Examination frequency is dependent upon the rating that the financial institution received in its previous examination. Based upon established federal criteria, financial institutions receiving a rating of either 1 or 2 are examined every 18 months while banks receiving a rating of 3 to 5 are examined every 12 months or more frequently.

Once the examination fieldwork is completed, the department's goal is to review and finalize bank examinations within 30 days for those conducted only by state examiners and within 60 days for joint examinations. However, department officials concede that they are not currently able to meet these goals. They report that on average the review time (including state and joint examinations) takes approximately 83 days. Although bank officials receive specific tentative information on the results of their examinations during their field exit with the department, the board is not typically provided a written analysis at the exit interview.

We reviewed department data on 286 state and joint examinations conducted from 2008 to 2011 to determine how long department examination reviews have been taking. We also compared the state-only and joint examinations with the department's goals of 30 and 60 days to review and finalize examinations to see how successful the department was in meeting its goals. See Exhibit 1 for a comparison of overall averages between state and joint examination review length.

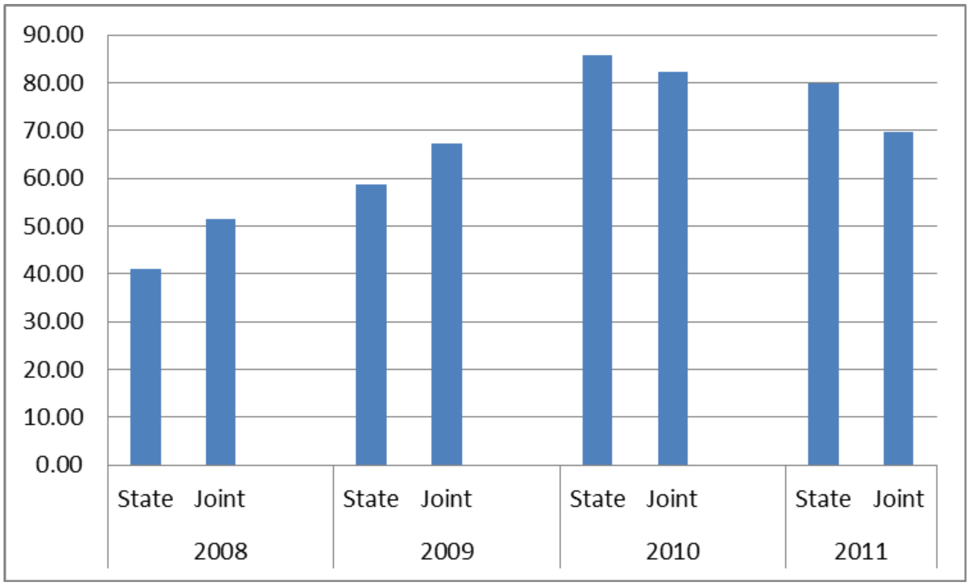
Exhibit 1
Average Number of Days for Bank Examination Reviews Compared
With Department Goals
Calendar Years 2008-2011



Source: Data obtained from Department of Financial Institutions staff. A total of 36 examinations were not included in the analysis. The department's Exam Tracking Report had incomplete information for 11 examinations, and as of the date the data were received, 25 examinations had not been completed.

We also developed a table showing a historical trend demonstrating the increase in review length for state and joint examinations for 286 examinations conducted from 2008 to 2011. See Exhibit 2 for the increase of state and joint review process time in days.

Exhibit 2
Bank Examination Review Average Length in Days
Calendar Years 2008-2011



Source: Data obtained from Department of Financial Institutions staff. A total of 36 examinations were not included in the analysis. The department's Exam Tracking Report had incomplete information for 11 examinations, and as of the date the data were received, 25 examinations had not been completed.

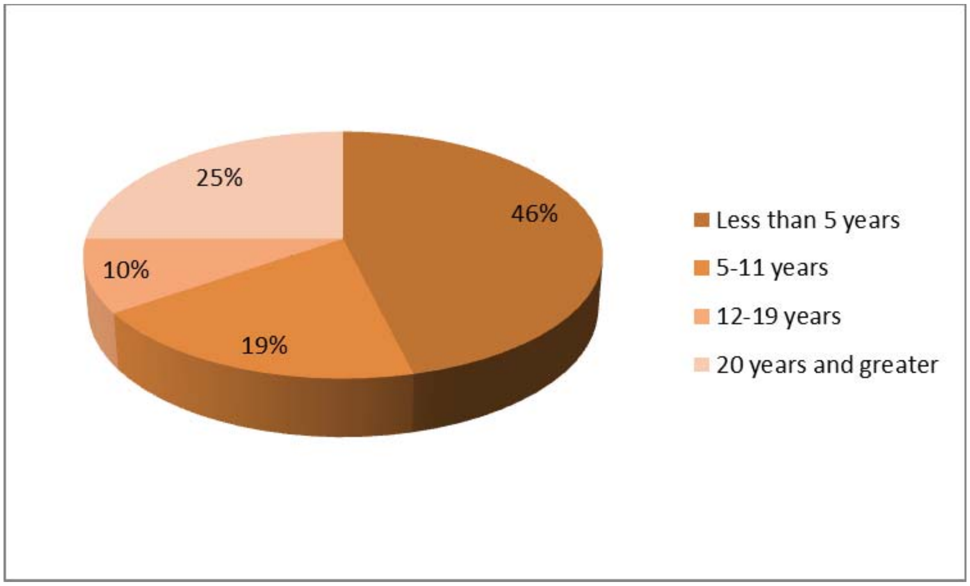
Factors Affecting Examination Review Timeliness

Department officials attribute this delay in completing examination reports to a number of factors. Namely, the economic downturn of 2008 resulted in an increase in the number of financial institutions receiving a CAMELS rating of 3, 4, or 5. As previously mentioned, the department examines financial institutions with a high CAMELS rating more frequently than those receiving a lower rating. Consequently, the department has had to conduct more examinations. Financial institutions with higher ratings also tend to have more problems, requiring a greater length of time and more staff to conduct effective examinations. According to department officials, these issues have resulted in examinations taking longer to review and finalize.

According to department officials, staff turnover of experienced bank examiners has also affected the department's examination efficiency. According to these officials, it takes approximately four to five years for examiners to become fully trained, but turnover has been high for examiners with this level of experience. Consequently, the amount of time necessary for senior staff to review and finalize reports is greater since they have to spend more time ensuring report quality. Our review of department data found that with the exception of 2009, when there was no turnover, the Bank Division lost at least two highly experienced examiners a year from 2007 to 2011. There are a total of 52 employees in the Bank Division, of which 34 are examiners. According to department officials, losing highly qualified examiners negatively affects division performance.

Department officials stated that not only does turnover of examiners affect the department's current exam performance, but it also places into question the department's ability to replace senior staff as they retire. Reportedly, bank examiner turnover has created a deficit of examiners with adequate experience to perform the functions of senior leadership. We observed that the department has very few examiners with 12 to 20 years of experience, which is the number of years department officials state are necessary to be adequately prepared to perform senior staff functions. See Exhibit 3 for a breakdown of current employees' experience levels.

Exhibit 3
Current Bank Division Employee Experience



Source: Data obtained from Department of Financial Institutions staff.

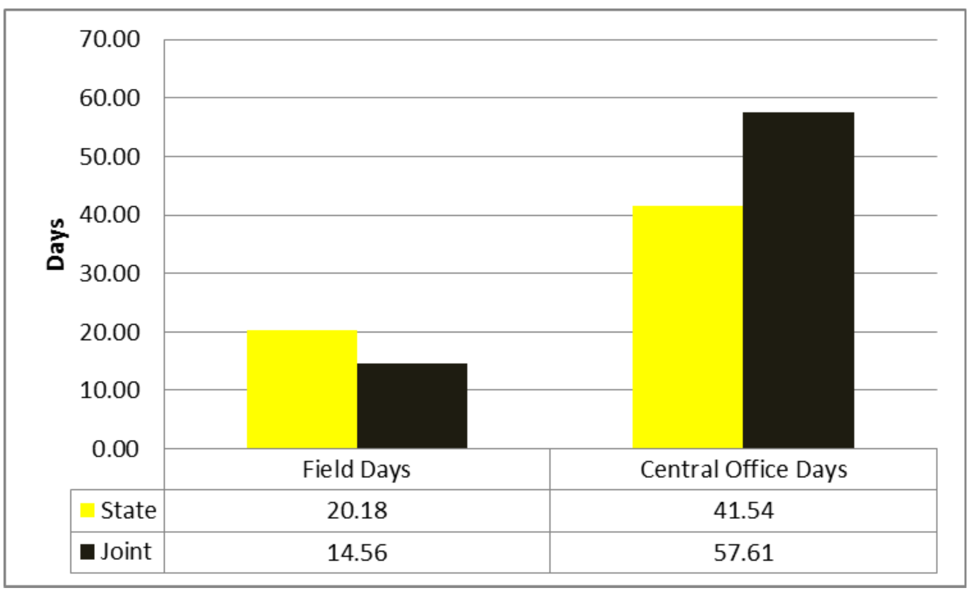
Department Efforts to Address Timeliness of Examination Review

Department officials have identified a problem with reviewing and finalizing examinations in a timely manner. Department officials conducting exit interviews with departing staff identified salary as the primary factor for staff quitting. Over the last year, Department of Financial Institutions officials have taken steps to help remedy this problem by working with the Department of Human Resources to increase salaries of Bank Division examiners in an effort to stem turnover. Department officials concede that the department cannot compete with its federal counterparts for comparable salaries. However, department officials assert that raising examiner salaries might help retain some examiners that might otherwise leave. Retaining examiners increases their experience and consequently their job skills. In doing so, department officials contend that department efficiency will improve.

The department has also implemented a top-to-bottom review to identify ways to streamline its review process. The assessment is attempting to identify what review steps can be minimized or eliminated without jeopardizing report quality.

Regional supervisors initially review bank examination reports and forward them to the department's central office for further review. To determine how long each portion of the review process takes, we compared department tracking data for 286 examinations completed from 2008 to 2011. We found that for state and joint examinations, the central office review time alone exceeded the department's goals of reviewing and finalizing examination reports within 30 days for state exams and came close to exceeding the department's goal of 60 days for joint exams. Moreover, we found that for state exams, field reviews almost consumed the department's entire goal of 30 days before reports were submitted to the central office for review. In their efforts to streamline the review process, department officials will need to examine both field and central office review processes. See Exhibit 4 for comparison of state and joint review processes in days.

Exhibit 4
Department of Financial Institutions Field and Office Review Days
Calendar Years 2008-2011



Source: Data obtained from Department of Financial Institutions staff. A total of 36 examinations were not included in the analysis. The department's Exam Tracking Report had incomplete information for 11 examinations, and as of the date the data were received, 25 examinations had not been completed.

Comment by the Commissioner of the Department of Financial Institutions

With respect to the observation titled "Department Efforts to Address Timeliness of Examination Review," we have the following comment. The department has been keenly aware of this situation for some time. In an effort to address this matter, we included in our top to bottom analysis a goal to hire two Safety and Soundness Administrators. This goal has been accomplished and has already improved our performance to some extent. Additionally, we are presently conducting a LEAN Event regarding examination report turnaround that we expect to produce several additional alternatives for improving our processes in this area. We fully expect that these efforts, combined with an improving banking environment, will reflect much improved examination report processing time going forward.

OTHER AUDIT WORK PERFORMED

The following topic, reviewed as part of our audit objectives, is included in this report to provide additional information on the activities of the Department of Financial Institutions.

Security of Information From Financial Institutions

The Department of Financial Institutions receives a variety of financial information from financial institutions it regulates. Often this information is provided to the department in an electronic data format, which the department is responsible for maintaining and securing. As part of the audit, we sought to identify what steps the department has taken to secure this sensitive information and determine whether those steps appeared adequate.

To accomplish this, we interviewed department officials from each division who are responsible for ensuring that sensitive information provided by financial institutions regulated by the department is secured. We also interviewed the department's director of information technology to further ascertain what steps the department has taken to secure sensitive information. Finally, we reviewed department policies and procedures that address the protection of electronic data.

Based upon information provided during our interviews with department staff and review of department policies, we determined that the department appears to have taken appropriate steps to protect electronic financial information. The basis for our assessment is as follows:

- The Credit Union Division has virtually no control of electronic financial information. Data it receives are immediately placed on computers provided by the National Credit Union Administration (NCUA). Information is subsequently sent to a server maintained by the NCUA. Access to this system is limited, and information on the server cannot be downloaded or printed.

- The Compliance Division receives a variety of information that ranges from confidential to information that is already made public. Department officials reported that confidential information includes criminal background reports, loan records, and financial statements. The FBI reviewed department policies regarding criminal background checks and found the policies to be acceptable. Information is secured within the department with access limited to specific staff and on examiner computers that are encrypted.

- The Bank Division receives data electronically from financial institutions that it regulates. This information is maintained in one of the three department field locations as part of an examination's working papers. Data are maintained on examiner computers, which are encrypted. While data can be exchanged between state and federal examiners on joint exams, data exchanges are supposed to be made only with either department or federal thumb drives that are encrypted. Reportedly, bank exam work papers are secured in field offices, with access limited to examiners or their respective supervisors.

- All department computers are encrypted.

- The department maintains some bank information on a server maintained by the Department of Finance and Administration, Office for Information Resources, which is regularly audited by the Division of State Audit.

Based upon the above information, it appears that the department has taken the necessary steps to minimize the threat of financial information being compromised.

Appendix

Performance Measures Information

As stated in the Tennessee Governmental Accountability Act of 2002, "accountability in program performance is vital to effective and efficient delivery of governmental services, and to maintain public confidence and trust in government." In accordance with this act, all executive branch agencies are required to submit annually to the Department of Finance and Administration a strategic plan and program performance measures. The department publishes the resulting information in two volumes of *Agency Strategic Plans*: *Volume 1 - Five-Year Strategic Plans* and *Volume 2 - Program Performance Measures*. Agencies were required to begin submitting performance-based budget requests according to a schedule developed by the department, beginning with three agencies in fiscal year 2005, with all executive-branch agencies included no later than fiscal year 2012. The Department of Financial Institutions began submitting performance-based budget requests effective for fiscal year 2007-2008.

The Department of Financial Institutions provided updated information on its performance measures for fiscal years 2009-2011. Detailed below are the Department of Financial Institutions' performance standards and performance measures.

Performance Standards and Measures

Performance Standard

Pursuant to statute, regulate and examine Tennessee state-chartered banks and Tennessee state-chartered credit unions.

Performance Measure

Number of Tennessee Department of Financial Institutions examinations and joint department/ Federal Deposit Insurance Corporation or Federal Reserve Board examinations of Tennessee state-chartered banks and joint department/National Credit Union Association examinations of Tennessee state-chartered credit unions.

Actual (FY 2008-2009)	Estimate (FY 2009-2010)	Target (FY 2010-2011)
149	151	175

The Bank Division's Chief Administrator reviews bank examination results for accuracy. Similarly, Credit Union Division supervisors, managers, analyst, and assistant commissioner review performance measure data for accuracy.

Performance Standard

Regulate institutions licensed or registered for compliance with governing acts.

Performance Measure

Number of non-depository financial institutions examined by the department in relation to the number of licenses.

Actual (FY 2008-2009)	Estimate (FY 2009-2010)	Target (FY 2010-2011)
4,412/5,281	4,130/4,374	4,288/4,287

The Compliance Division is charged with the licensing and regulation, through the examination of licensees, of non-depository financial institutions engaged in lending activities subject to the department’s supervisory authority.