State Auditor's Office

John Keel, CPA
State Auditor

A Supplemental Audit Report on

The Department of Banking

November 2009

Report No. 10-012

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Overall Conclusion

With respect to its examinations of state-chartered commercial banks for which the Federal Deposit Insurance Corporation (FDIC) is the federal oversight entity, the Department of Banking (Department) complies with applicable statutes, administrative rules, and Department policies in (1) monitoring the safety and soundness of those banks and (2) providing sufficient oversight of commercial banks identified as having a poor or deteriorating financial condition. Auditors also concluded that the Department's off-site monitoring tools were effective. However, auditors identified opportunities for the Department to strengthen controls in areas such as:

- Ensuring that it includes all issues identified during an examination in the examination report or documents the reasons it did not include these issues in the examination report.
- Completing all examination procedures and ratings.
- Processing examination reports in a timely manner. For example, the Department did not process 15 (50.0 percent) of 30 examinations tested within the required time frames.
- Contacting banks within required time frames between examinations.

Background Information

The Department of Banking (Department) supervises and regulates all state-chartered banks in Texas. As of March 11, 2009, the Department regulated 325 state-chartered banks.

The Department's appropriations for fiscal years 2008 and 2009 were $18,042,032 and $17,810,029, respectively. The Department is authorized to have 222.5 full-time equivalent (FTE) employees, but it employed 171.15 FTEs as of the second quarter of fiscal year 2009.

The Finance Commission of Texas (Commission) oversees the Department. The Commission appointed the Department's current Banking Commissioner, Charles G. Cooper, on December 1, 2008.

This audit report is the result of the continuation of a prior State Auditor's Office audit conducted at the Department from March 2009 to May 2009 (see *An Audit Report on the Department of Banking*, State Auditor's Office Report No. 09-043, July 2009). The July 2009 audit report included information regarding an audit scope limitation because the FDIC had not permitted the State Auditor's Office to access information necessary to address the objectives of the audit. After that audit report was published, the FDIC granted conditional access to certain records in August 2009 (see Appendix 2 for the FDIC's letter). This audit report covers only the audit work performed after the receipt of the conditional access to examinations of commercial banks for which the FDIC is the federal oversight entity.

This audit was conducted in accordance with Texas Government Code, Section 321.0132.

For more information regarding this report, please contact Mike Apperley, Assistant State Auditor, or John Keel, State Auditor, at (512) 936-9500.

Summary of Management's Response

The Department generally agreed with the recommendations in this report.

Summary of Objectives, Scope, and Methodology

The objectives of this audit were to determine whether the Department complies with applicable statutes, administrative rules, and agency policies in:

- Monitoring the safety and soundness of state-chartered commercial banks.
- Overseeing the commercial banks identified as having a poor or deteriorating financial condition.

The audit scope covered the Department's bank examinations and enforcement and administrative actions from January 2006 to March 2009 at banks for which the FDIC was the federal oversight entity. While the Department alternates examinations of state-chartered commercial banks and conducts some examinations jointly with the FDIC, the FDIC's activities were not included in the scope of this audit. As a result, this audit report provides no assurance regarding the effectiveness or appropriateness of the FDIC's activities. In a prior audit report, the State Auditor's Office reported on additional work related to the audit objectives (see *An Audit Report on the Department of Banking,* State Auditor's Office Report No. 09-043, July 2009.) That report should be considered in conjunction with this report.

This audit did not include any reviews of information technology.

The audit methodology included collecting information and documentation; reviewing policies and procedures and other documentation; conducting interviews with Department management and staff; testing bank examinations for compliance with statutes, rules, and policies; and evaluating the results of testing and observations.

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Detailed Results

Chapter 1

The Department Complies with Requirements for Examinations of Commercial Banks for Which the FDIC Is the Federal Oversight Entity; However, the Department Should Strengthen Its Review Process

The Department of Banking (Department) performs bank examinations of state-chartered commercial banks for which the FDIC is the federal oversight entity in accordance with applicable statutes, administrative rules, and Department policies.

The CAMELS Rating System

The Federal Financial Institutions Examination Council uses the CAMELS rating system as a supervisory tool to evaluate financial institutions. Each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations:

- **C**apital adequacy.
- **A**sset quality.
- **M**anagement practices.
- **E**arnings performance.
- **L**iquidity position.
- **S**ensitivity to the market.

The CAMELS rating system includes a rating for each component and an overall composite CAMELS rating. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and a rating of 5 indicating the most critically deficient level of performance.

Auditors confirmed that the Department conducted the following procedures during its examinations of 30 state-chartered banks for which the FDIC was the federal oversight entity:

- Reviewed high-risk loans.
- Assigned appropriate CAMELS ratings that were supported by the examination documentation (see text box for information on the CAMELS rating system).
- Ensured that proper authorities signed the examination reports.
- Analyzed investments.
- Reviewed loans for out-of-state branch operations (if necessary).
- Ensured that its examiners were independent.

However, the Department should improve certain examination processes. Specifically:

- The Department did not consistently ensure that all issues identified during an examination were included in the examination report or that it documented the reasons it did not include these issues in the examination report. Three (10.0 percent) of 30 examinations tested identified issues noted as “report worthy” by the examiner conducting the review; however, for these three examinations, the issues were not included in the examination report. For a fourth examination tested, it was not possible to determine whether all issues were included in the report because a summary of findings was not completed for one of the examination procedures. The Department’s Examiners Bulletins CL 2007-01 and

2006-01 require all weaknesses to be clearly labeled as "not report worthy" in the summary of findings if they will not be included in the examination report.

- The Department did not ensure that all examination procedures were assigned a rating for 3 of 30 examinations tested. For example, for two examinations, examination staff did not assign a rating to the summary of findings for the loan review procedure. The Department's Examiners Bulletins CL 2007-01 and 2006-01 state that the summary of findings should be completed to support a rating. The summary of findings is not completed if no rating is assigned.

- The Department did not complete all examination procedures or did not document that a procedure was waived for 5 of 30 examinations tested. (Department policy requires the examiner in charge to sign a waiver form if a procedure will not be performed for that bank examination.) For one of the five examinations, the examiner in charge did not document work conducted for the management practices procedure. The examiner in charge did not identify this issue during the review and completion of procedure steps.

- The Department did not process examination reports within the required time frame for 15 (50.0 percent) of 30 examinations tested. Fourteen of the 15 examination reports were processed between 4 and 28 days late. For the remaining examination that was processed late, the Department explained that this examination was not typical and, as a result, did not follow the normal processing time frame. The Department's policy requires examination reports to be processed within 35 days at headquarters or within 23 days at a regional office. Regional offices are responsible for processing examinations for banks with CAMELS ratings of 1 or 2.

The issues discussed above indicate that the Department's review process is not working as intended and should be strengthened. Weaknesses in the review process could result in important issues not being included in the examination report, which could potentially affect a bank's overall CAMELS rating.

Recommendations

The Department should:

- Evaluate its quality review processes to ensure that this function (1) identifies all issues that should be included in the examination report or (2) documents the reasons that issues identified as "report worthy" in the procedures were not included in the examination report.

- Verify that its staff complete all examination procedures and assign ratings to procedures in accordance with Department policy or document through a waiver form the specific examination procedures that are waived and will not be completed.
- Improve its timeliness in processing examination reports to comply with its internal policy.

Management's Response

The Department believes that its policies and procedures are adequate, but agree that staff efforts to comply with internal documentation requirements need to improve in the few instances noted. Each bank examination has a possibility of 27 different procedures being performed by members of the review team. Regarding the 30 examinations reviewed by the State Auditor's Office, somewhere around 630 work procedures were performed. To address this issue Regional Directors will meet with their staff and again stress the importance that individuals working each assignment take responsibility and ensure their work is complete and accurate, which includes completing the Summary of Findings page. Failure to adequately document their assigned work product will be documented in their review critique.

Regarding procedures that are not performed, usually due to low risk or materiality, Examiners-in-charge will be held responsible for documenting the reasons they were not performed. Failure to fully document and complete will result in a "Fails to Meet Standards" regarding their performance for the respective review.

The Department agrees that a large number of examination reports have not been processed within internal policy guidelines. This is due primarily to: an increase in the number of examinations with high risk ratings that must be processed through headquarters; the need to coordinate supervisory responses for these high risk institutions with their federal regulator; a significant increase in the number of supervisors in banks that rely on the review staff as their primary contact; and turnover within the review examiner staff at headquarters. The processing of examination reports continues to be monitored through weekly status reports that are distributed to the Deputy Commissioner. To address this issue, the Bank & Trust Supervision Division has increased the number of review staff at headquarters to four from two. Further, a less tenured examiner is being rotated in the review process every two months to handle routine correspondence and surveillance activities.

Chapter 2

The Department Should Ensure That It Conducts Examinations of Commercial Banks for Which the FDIC is the Federal Oversight Entity in a Timely Manner

Auditors tested the timeliness of 10 bank examinations the Department conducted between January 1, 2006, and March 31, 2009, at commercial banks for which the FDIC is the federal oversight entity. The Department conducted 3 (30.0 percent) of those 10 examinations late. The 3 examinations were conducted an average of 41 days late. It is important to note, however, that none of the late examinations was for a bank with a CAMELS rating of 3, 4, or 5. The Department recently revised its internal policy for examination due dates, and under the new guidelines, only two of the examinations would fall outside the new parameters for timeliness. If examinations are not conducted on time, there is an increased risk that problem banks will not be identified in a timely manner.

Recommendation

The Department should ensure that it conducts the bank examinations in a timely manner in accordance with its policy.

Management's Response

The Department closely monitors its timeliness in conducting examinations within the prescribed time and reports this information at each Finance Commission meeting. Unfortunately, examination priority dates are very specific and as mentioned, no high risk institutions were examined late. When necessary due to risk and priority status, examinations for low risk institutions will be pushed back to address more pressing supervisory responsibilities. Occasionally, banks will have issues such as pending mergers, acquisitions, system conversions or management absences that also need to be considered in establishing an efficient examination schedule. Further, the Department must coordinate joint examination activities with federal regulators and must consider their ability in meeting scheduled review times. And, the Department has job postings to hire experienced examiners for limited term positions to supplement our current staff through this period of increased economic distress.

Chapter 3

The Department Provides Sufficient Oversight of Commercial Banks for Which the FDIC Is the Federal Oversight Entity and That Have Been Identified as Having a Poor or Deteriorating Financial Condition

Administrative and Enforcement Actions

The Department is authorized to impose administrative and enforcement actions upon banks under its supervision. These actions are designed to address and correct specific problems identified during an examination and may include:

- Board resolution.
- Commitment letter.
- Memorandum of understanding.
- Determination letter.
- Cease and desist order.
- Order of removal of officer, director, employee, or controlling shareholder.
- Order of supervision.
- Order of conservatorship.

Based on the administrative and enforcement actions auditors reviewed, the Department complies with applicable statutes, administrative rules, and agency policy in overseeing banks for which the FDIC is the federal oversight entity and that have a poor or deteriorating financial condition. The Department has the authority to impose various administrative and enforcement actions for banks identified as having a poor or deteriorating financial condition (see text box), and those actions are appropriate, effective, and consistently applied.

Auditors reviewed a sample of administrative and enforcement actions for 30 banks regulated by the FDIC and identified no errors.

Chapter 4

The Department's Ongoing Monitoring Program Provides Supervisory Attention to Banks for Which the FDIC is the Federal Oversight Entity and That Have a High-risk Profile

The Department has implemented processes to conduct off-site monitoring between on-site examinations at state-chartered banks. These processes include the use of:

- An exception monitoring report.
- A bank watch list.
- A bank call program.
- An off-site bank monitoring program.
- Priority monitoring reports.

Definition of a Problem Bank

Problem banks have one or more of the following characteristics:

- Have an overall CAMELS rating of 3, 4, or 5.
- Are subject to a formal or informal administrative action.

Problem banks are placed on a quarterly bank watch list because they warrant close monitoring. The Department's primary monitoring report captures examination due dates for problem banks so that Department management is knowledgeable of problem banks' next examination date.

Auditors verified that the Department received all progress reports from problem banks for which the FDIC is the federal oversight entity in a timely manner, and these reports identified the banks' efforts to remedy the problem(s). Auditors also verified that the Department placed problem banks on the quarterly watch list and the primary monitoring report until banks resolved the issues. Auditors identified no errors during testing of administrative/enforcement actions; therefore, for the limited number of actions tested, auditors concluded that the Department's off-site monitoring program provides adequate supervision of banks identified as a problem bank.

Based on changes in banks' CAMELS ratings since the banks' previous examinations, auditors determined that the Department's off-site monitoring program is effective. One (3.3 percent) of 30 banks tested had a CAMELS rating that increased by more than 1 point since the previous examination, and Department management acknowledged that this was a result of the limitations of off-site monitoring. Specifically, the Department may not be able to determine deterioration in a bank's asset quality without conducting an on-site examination. The remaining 29 banks tested had CAMELS rating that remained within one point of their previous CAMELS ratings, which indicates that off-site monitoring tools are effective.

For lower risk banks (banks with CAMELS ratings of 1 or 2), the Department should strengthen controls regarding its contact with banks. For 16 (53.3 percent) of 30 banks with CAMELS ratings of 1 or 2 that auditors tested, the Department did not contact the bank within the first half of the examination cycle as required by Department policy. On average, the Department contacted these 16 banks 48 days late. The bank examination schedule for banks with CAMELS ratings of 1 or 2 is either 12 months or 18 months, depending on asset size.

The Department does not monitor the due dates for its call monitoring program because it considers the call monitoring program to be a tool it uses to maintain contact with bank management between examinations and not a tool to identify problem banks. In response to the State Auditors Office's July 2009 report (*An Audit Report on the Department of Banking*, State Auditor's Office Report No. 09-043), the Department revised its internal guidelines to amend the time frame for contacting the banks from "within the first half of the examination cycle" to a 120-day window described as 60 days before or 60 days after the mid-point of the examination plan cycle.

Recommendation

The Department should consistently contact banks in accordance with its internal policies.

Management's Response

As stated, the Department has revised its internal policy to allow a more flexible and workable time period to contact bankers between examinations. The Banker Call Program is not designed to identify risk, but to encourage a free exchange of information between the Department and bankers outside the normal examination process. This issue has been discussed with the Regional Directors and they have been strongly encouraged to comply with this program. Further, the Department's staff continues to attend numerous banking functions attended by many of our state-chartered institutions and engage in open dialogue about current supervisory issues.

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to determine whether the Department of Banking (Department) complies with applicable statutes, administrative rules, and agency policies in:

- Monitoring the safety and soundness of state-chartered commercial banks.
- Overseeing the commercial banks identified as having a poor or deteriorating financial condition.

Scope

The audit scope covered the Department's bank examinations and enforcement and administrative actions from January 2006 to March 2009 at banks for which the Federal Deposit Insurance Corporation (FDIC) was the federal oversight entity. While the Department alternates examinations of state-chartered commercial banks and conducts some examinations jointly with the FDIC, the FDIC's activities were not included in the scope of this audit. As a result, this audit report provides no assurance regarding the effectiveness or appropriateness of the FDIC's activities. In a prior audit report, the State Auditor's Office reported on additional work related to the audit objectives (see *An Audit Report on the Department of Banking*, State Auditor's Office Report No. 09-043, July 2009.) That report should be considered in conjunction with this report.

This audit did not include any reviews of information technology.

Methodology

The audit methodology included collecting information and documentation; reviewing policies and procedures, statutes, and rules for Department management and examiners; conducting interviews with Department management and staff; testing bank examinations for compliance with statutes, rules, and policies; and evaluating the results of testing and observations.

<u>Information collected and reviewed</u> included the following:

- Policies and procedures for Department examinations, administrative/enforcement actions, and off-site monitoring.

- Bank examination reports, procedures, and working papers of state-chartered banks regulated by the FDIC and the Department.
- Administrative/enforcement actions for banks regulated by the FDIC and the Department, corresponding bank responses, quarterly progress reports, bank watch lists, and priority reports.
- Exception monitoring reports and analysis for banks regulated by the FDIC and the Department.
- Bank CAMELS ratings in the bank examination database and CAMELS variance reports, if necessary.

Procedures and tests conducted included the following:

- Reviewed and tested policies and procedures for bank examinations, administrative/enforcement actions, and the off-site monitoring program for banks regulated by the FDIC.

Criteria used included the following:

- Department supervisory memorandums 1001, 1003, 1005, 1007, 1008, and 1016.
- Department administrative memorandums 2009, 2015, 2022, 2031, and 2041.
- Department policies and procedures for bank examinations.
- Department Examiner Bulletins CL 2008-01, CL 2007-01 and CL 2006-01.
- Department cooperative agreement with the FDIC.

Project Information

Audit fieldwork was conducted from August 2009 through September 2009. With one exception, 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. Government Auditing Standards, Section 7.80(b), requires auditors to document the work performed to support significant judgments and conclusions, including descriptions of transactions and records examined. We did not comply with that standard, because we did not document the names of the financial institutions associated with the examination reports we tested. Due to the sensitive nature of the information, we did not document that information so that we could comply with the terms of a confidentiality agreement between the State Auditor's Office and the Department of Banking.

We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The following members of the State Auditor's staff performed the audit:

- Kathy Aven, CFE, CIA (Project Manager)
- Kelley Bellah, CFE (Assistant Project Manager)
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)

Appendix 2

FDIC Approval for the State Auditor's Office to Access Department Information

A letter from the Federal Deposit Insurance Corporation (FDIC) granting the State Auditor's Office access to the Department of Banking's (Department) information is presented below.

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990 Division of Supervision and Consumer Protection

August 17, 2009

Mr. John Keel, CPA
State Auditor
State Auditor's Office
P.O. Box 12067
Austin, Texas 78711-2067

RE: Part 309 Request: Access to Exempt Information

Dear Mr. Keel:

The Federal Deposit Insurance Corporation (FDIC) has received your written request seeking the discretionary disclosure of certain exempt records relating to the insured Texas state-chartered financial institutions listed in your April 24, 2009, letter to Tom Dujenski, Regional Director, FDIC Dallas Regional Office. Your letter requests access to confidential supervisory information that is maintained by the Texas Department of Banking and the Texas Department of Savings and Mortgage Lending (Departments), and that was prepared with or is jointly owned by the FDIC, in order to fulfill your statutory duty to audit the Departments. You represent in your letter that work papers of your office are exempt from public disclosure and that any information obtained regarding the requested institutions will only be used to fulfill the specified audit objectives. You further state that you understand that the requested records are subject to the confidentiality requirements of Section 309.6(a) of the FDIC Rules and Regulations, 12 C.F.R. § 309.6(a). Lastly, you represent that confidential documentation obtained to support audit conclusions will not be retained after the conclusion of the audit process.

On the basis of your representations and under the discretionary authority outlined in Section 309.6(b) of the FDIC Rules and Regulations, your request is hereby approved as follows:

> The FDIC approves your office obtaining access to the confidential supervisory information maintained by the Departments that is jointly prepared or owned by the FDIC, for the time period and institutions specified in your request. The scope of such access shall be in accordance with existing information sharing practices between your office and the Departments for confidential information that is not shared jointly with the FDIC.
>
> To the extent that FDIC served as lead/examining agency for any relevant reports of examination, your office should contact the FDIC Dallas Regional Office to gain access to the related work papers. We ask that such work papers not be removed from FDIC offices during your review, and that no copies be retained by your office. We also reserve the right to redact portions of any of these documents to remove material created by FDIC examiners or otherwise not bearing on your inquiry.

Pursuant to the provisions of Section 309.6(b)(ii), access to the requested documents is granted with the understanding that the following conditions shall apply:

(1) your office may not use the confidential supervisory information made available to it pursuant to this letter for any purpose other than in connection with its audit(s) of the Departments;

(2) by granting access to you, the FDIC does not waive any claim of privilege or confidentiality with respect to the documents, as set forth in Part 309 of the Rules;

(3) upon the completion of your review of the documents, your office will either promptly return to the applicable Department, or certify the destruction of, any copies; and

(4) your office shall not disclose or further disseminate the exempt information for any purpose without the prior written approval of the FDIC's Dallas Regional Director, and your office shall comply with the prohibitions against disclosure contained in Part 309 of the Rules.

If you cannot agree to these conditions, please inform the FDIC immediately.

Moreover, if the Texas State Auditor's Office is requested to produce any of the disclosed exempt documents pursuant to any subpoena, request, or any applicable disclosure statute or regulation, please provide prior written notice of such intended production to the FDIC Dallas Regional Office. We understand that you will assert all applicable privileges, immunities, and exceptions to all production requests, including without limitation those identified in 5 U.S.C. §§ 552(b)(3), (b)(7) and (b)(8).

We trust that the access to exempt information granted herein is responsive to your request. If you have any additional questions, please contact Regional Director Thomas J. Dujenski (972-761-8290), 1601 Bryan Street, Dallas, Texas 75201-3430.

Sincerely,

Serena L. Owens
Associate Director

Cc: Regional Director Thomas J. Dujenski
Charles G. Cooper, Commissioner, Department of Banking
Douglas Foster, Commissioner, Department of Savings and Mortgage Lending

Appendix 3

Related State Auditor's Office Work

Related SAO Work		
Number	**Product Name**	**Release Date**
09-043	An Audit Report on the Department of Banking	July 2009

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Steve Ogden, Senate Finance Committee
The Honorable Thomas "Tommy" Williams, Member, Texas Senate
The Honorable Jim Pitts, House Appropriations Committee
The Honorable Rene Oliveira, House Ways and Means Committee

Office of the Governor

The Honorable Rick Perry, Governor

Members of the Finance Commission of Texas

Mr. W.J. (Bill) White, Chair
Mr. Darby Byrd
Mr. David J. Cibrian
Mr. Riley Couch
Ms. Stacy London
Ms. Cindy F. Lyons
Ms. Lori B. McCool
Mr. Jonathan Bennett Newton
Mr. Paul Plunket

Department of Banking

Mr. Charles G. Cooper, Commissioner