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An Audit Report on

The Department of Savings and Mortgage Lending

August 2009
Report No. 09-049



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Overall Conclusion

Due to limitations on the scope of this audit, the State Auditor's Office was unable to determine whether the Department of Savings and Mortgage Lending (Department) is meeting its responsibilities under all applicable statutes, administrative rules, and agency policy. Although auditors performed a limited review of the Department's policies and procedures for examinations and monitoring of state-chartered savings banks and savings and loan associations, it was not possible to determine (1) whether the Department applied these policies and procedures or (2) whether these policies and procedures were effective.

Because the institutions the Department regulates are subject to Federal Deposit Insurance Corporation (FDIC) regulations, all evidence of the Department's examinations, enforcement, and many of its monitoring activities is restricted under federal regulations.¹ Texas Government Code, Section 321.013(e), specifies that the State Auditor's Office may access this information only with the approval of the appropriate federal agency; however, the FDIC did not permit the State Auditor's Office to access this information. The denial of access to certain records limited the scope of the audit (see Appendix 2).

The Department conducts its examinations in conjunction with federal regulators and, as a result, the FDIC's Office of Inspector General may review some of the Department's examination work papers if the FDIC relied upon those as support for an FDIC report. However, the FDIC does not have any oversight authority over the Department.

The Department is a member of the American Council of State Savings Supervisors, a national professional association of state-chartered savings institution regulators. However, this association does not provide any form of oversight, accreditation, or peer review. In addition, effective September 1, 2009, the Department will

Background Information

One of the Department of Savings and Mortgage Lending's (Department) strategies is to charter, regulate, examine, and supervise state-chartered savings banks and savings and loan associations. The Department's mission for this strategy is to ensure the safety and soundness of these institutions. The Finance Commission of Texas oversees the Department (see Appendix 3).

In fiscal year 2008, the Department received General Revenue appropriations of \$6.6 million and was authorized to have 108 full-time equivalent employees. In fiscal year 2009, the Department received General Revenue appropriations of \$6.8 million and was authorized to have 111 full-time equivalent employees. These figures include all Department strategies.

¹ See FDIC regulations in Title 12, Code of Federal Regulations, Chapter III.

become a self-directed and semi-independent agency under House Bill 2774 (81st Legislature, Regular Session). As a self-directed and semi-independent agency, the Department will have greater autonomy over its operations. The bill removed the Department from the legislative budgeting process, and its budget will be adopted and approved only by its policy-making body, the Finance Commission of Texas. The bill also requires the State Auditor's Office to contract with the Department to conduct financial and performance audits.

Although auditors were unable to determine whether the Department is meeting its statutory responsibilities, testing that auditors were able to perform identified the following issues:

- The Department does not always perform on-site examinations within the time frames specified on its examination schedule. At a minimum, 10 (26 percent) of the 38 examinations the Department performed between August 2005 and January 2009 did not have examinations performed in a timely manner. The average delay was 59 days.
- The Department does not have documentation supporting that it verified that the examiners it hires are commissioned by the FDIC, the federal Office of Thrift Supervision, or other qualified organizations. Individuals can assert that they are commissioned when they are hired, but the Department was unable to provide evidence that it verifies those assertions.
- The Department does not consistently rotate the examiners or the examiners in charge when it performs examinations of the institutions it regulates. Fifteen (75 percent) of 20 institutions were examined by the same examiners for at least three consecutive years.
- The Department should improve processes to ensure the independence of its examiners. In August 2008, the Department began requiring its examiners to sign an annual acknowledgment that they have read certain policies (including a conflict of interest policy and an outside employment and financial interests policy). However, disclosure of outside employment, business activities, relationships, or financial interests is entirely dependent on the employee.

Auditors communicated other, less significant issues to the Department separately in writing. Auditors also identified a weakness in information technology controls at the Department; however, to minimize the risks associated with disclosure, auditors communicated details regarding that weakness directly to the Department in writing.

Summary of Management's Response

The Department is in general agreement with the recommendations in this report.

Summary of Information Technology Review

Auditors assessed the information technology (IT) controls over databases the Department uses to monitor institutions' financial data. Auditors evaluated general IT controls such as logical access, program changes, physical security, and disaster recovery. Auditors also evaluated application controls such as input controls, process controls, and output controls.

Although the Department has implemented controls to protect its information technology resources, it should strengthen certain controls in this area. For example, control weaknesses resulted in inaccurate quarterly monitoring reports in 12 of 16 quarterly monitoring reports that auditors tested.

Summary of Objectives, Scope, and Methodology

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

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

The scope of this audit included activities related to the Department's monitoring and examination of institutions from August 1, 2005, through March 31, 2009. The State Auditor's Office is reporting a scope limitation because auditors were not permitted to access certain records and could not determine whether the Department complied with applicable statutes, administrative rules, and agency policy in overseeing institutions identified as having a poor or deteriorating financial condition.

The audit methodology included review of applicable laws, statutes, rules, regulations, and Department policies and procedures; analysis of data from Department information systems; review of examiner personnel and training files; review of Department institution examination dates; and interviews with Departmental employees and management.

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Detailed Results

Chapter 1

The Department Should Strengthen Controls Over Its Examination and Monitoring Processes

Auditors were unable to determine whether the Department of Savings and Mortgage Lending (Department) is meeting its responsibilities under all applicable statutes, administrative rules, and agency policies due to a scope limitation on this audit (see Appendix 2 for additional details). However, auditors were able to perform limited tests of the Department's examination and monitoring processes.

The Department conducts its examinations in conjunction with federal regulators and, as a result, the Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General may review some of the Department's examination work papers if the FDIC relied upon those as support for an FDIC report. However, the FDIC does not have any oversight authority over the Department. In addition the Department is a member of the American Council of State Savings Supervisors (a national professional association of state-chartered savings institution regulators); however, no organization makes any determination regarding whether the Department is meeting its responsibilities under all applicable state statutes, administrative rules, and Department policies. The Department does not receive any other form of oversight, accreditation, or peer review.

The Department should consistently perform examinations in a timely manner.

The Department should consistently perform examinations in a timely manner in accordance with its rules and policies. In addition to its own policies, the Department has adopted the FDIC's examination policies and procedures. Federal regulations require that a full scope, on-site examination be conducted at each institution at least once during each 12-month period.² Prior to April 2007, institutions with total assets of less than \$250 million could be examined at least once each 18-month period, rather than each 12-month period. After April 2007, the federal regulations were amended and total assets size for the 18-month examination period was increased to \$500 million. However, the Department's *Supervisory Manual*, which contains its policies for examinations, as well as its adopted FDIC examination policies and procedures have not been updated to reflect the change in asset size.

To qualify for the 18-month examination period, institutions must meet other requirements (in addition to having assets of less than \$250 million). While

² See FDIC regulations in Title 12, Code of Federal Regulations, Section 337.12

auditors could verify which institutions qualified for an 18-month examination based on each institution's asset size, auditors were unable to verify whether any of these institutions were disqualified based on the other requirements due to the scope limitation on this audit (see Appendix 2 for additional details).

As of December 31, 2008, the Department was responsible for regulating 28 institutions (see Appendix 4 for a list of those institutions). Between August 2005 and January 2009, the Department conducted 38 examinations at these institutions. Auditors reviewed the timing of those examinations and determined the following:

- The Department generally complied with its policies for 18-month examinations. Nineteen (50 percent) of the 38 examinations tested qualified for an 18-month examination based upon asset size. Seventeen (89 percent) of those 19 institutions were examined within 18 months of the prior examination start date; however, 2 (11 percent) were not. The maximum delay was 31 days, and the average delay was 18 days.
- The Department did not consistently comply with its policies for 12-month examinations. Eight (21 percent) of the 38 examinations tested qualified for a 12-month examination based upon asset size. Five (62 percent) of those 8 institutions were examined within 12 months of the prior examination's start date; however, 3 (38 percent) were not. The maximum delay was 222 days, and the average delay was 158 days. (While federal regulations allow these examinations to be conducted within 18 months of the prior examination date, the Department's policy requires that these examinations be conducted within 12 months of the prior examination date.)
- The Department did not consistently comply with its policy to perform limited examinations of newly chartered institutions within the first six months of operation. Six (16 percent) of the 38 examinations tested were for newly chartered institutions that qualified for a limited examination. Two (33 percent) of those six institutions were examined according to the Department's time lines; however, 4 (67 percent) were not. The maximum delay was 46 days, and the average delay was 19 days.
- The Department generally complied with its policy to perform full examinations of newly chartered institutions within the first twelve months of operation. Five (13 percent) of the 38 examinations tested were for newly chartered institutions that qualified for a full examination. Four (80 percent) of those five received the full examination within the 12-month time frame; however, 1 (20 percent) did not. The delay for the newly chartered institution that did not receive the full examination within 12 months was 6 days.

The Department should consistently rotate examiners across institutions.

Regulatory best practices suggest that individuals performing in a regulatory capacity be rotated periodically to ensure independence from the organizations they are regulating. Fifteen (75 percent) of the 20 institutions available for three consecutive Department examinations from January 2006 to March 2009 were examined by the same Department examiner for at least three consecutive years. One of the 15 institutions was examined by the same examiner for a fourth year.

The Department has adopted an FDIC policy that assigns each institution a “Relationship Manager” to ensure continuity. The FDIC policy states, “However, having a different examiner serve as the examiner-in-charge may foster objectivity if the Relationship Manager has dealt with the bank for some time. Examiner independence is crucial, and field supervisors will rotate examiner-in-charge assignments periodically to ensure fair and objective treatment for all institutions.” While the relationship manager will attend the bank examinations to which he or she is assigned and may occasionally perform as the examiner in charge, the examiner in charge should not perform examinations at the same institutions continuously. In the case of the institution that was examined by the same Department examiner for four consecutive years, the examiner performed:

- As the examiner in charge for three of those four years,
- As the Relationship Manager for one of those four years.

Rotating examiners across the institutions would help to ensure examiner independence and objectivity.

The Department should strengthen its monitoring of examiners.

Department examiners conduct their examinations on site at institutions throughout the state, traveling directly from their homes to the examination locations. As a result, the majority of the Department’s examiners typically do not live around the Department’s offices. Supervision over examiners’ work during examinations takes place on site by the examiner in charge. Auditors identified opportunities for the Department to strengthen its monitoring of examiners in the areas of examiner commissioning, examiner training, and policies regarding examiner independence and conflicts of interest.

The Department should verify examiner qualifications. The Department did not have documentation supporting that it verified individuals were credentialed to perform as an examiner in charge when the Department hired them as examiners. All examinations are led by an examiner in charge. The examiner in charge is an experienced examiner who directs the examination. To perform as an examiner in charge, an examiner must be commissioned. An

examiner may earn his or her commission from a variety of entities including the FDIC and the federal Office of Thrift Supervision.

The Department could not initially provide any documentation to support that it verified whether examiners were commissioned. However, the Department subsequently obtained documentation supporting the commissions of 4 (33 percent) of the 12 examiners who had performed as examiners in charge between January 2006 and March 2009.

The Department should monitor compliance with its examiner training policy. Department policy requires personnel in the examination and supervision functions to attend at least 40 hours of training annually. However, the Department's training database records only the name of the course taken and the date attended; it does not record the number of hours per course. Therefore, the Department is unable determine whether its personnel meet the 40-hour training requirement.

The Department should improve its policies regarding independence and conflicts of interest. The Department substantially complies with Texas Finance Code requirements regarding independence and conflicts of interest, but it should improve its policies in these areas.

Department policy requires employees to sign an annual acknowledgment that they have read certain policies, including the conflict of interest policy and the outside employment and financial interests policy. (The Department did not implement this policy until August 2008. Prior to August 2008, there was no requirement for an annual or periodic review and acknowledgement after the initial policy acknowledgment on the date of hire.)

In addition to requiring employees to acknowledge that they have read certain policies, the Department should strengthen its policies by requiring employees to complete annual forms that specifically disclose any potential conflicts of interest, outside employment, or potential violations of the financial interests policy. This disclosure also should include a statement that none of the conditions disclosed represents a conflict of interest. This would enable Department management to better monitor the objectivity of its employees.

The Department should update its *Supervisory Manual* to reflect current practices.

The Department's *Supervisory Manual*, which is "intended as a resource for supervisory analysts in fulfilling their responsibilities," does not fully reflect current Department practice. The Department last revised this manual in March 2005 by means of a cover page; however, the Department did not incorporate revisions into the body of the manual and the "revised as of" date specified on each page of the manual reads "September 2002." Personnel using the manual must refer to the cover page and based on their interpretation

incorporate those changes themselves, which increases the risk that changes may not be followed. Specifically:

- Numerous manual sections, including the sections for State Examination Reports, Federal Examination Reports, Independent Audit Reports, and Supervisory/Financial Monitoring Reports, use obsolete titles for the parties responsible for key tasks. Examples of the obsolete titles used include the Corporate Activities Administrative Assistant and the Director of Corporate Activities. While the Department asserts that the functions and responsibilities have been continuously assigned and performed, the manual does not reflect this practice.
- The section of the manual that details the calculation, content, and presentation of monitoring reports the Department uses to oversee the financial condition of institutions does not reflect current practice. For example, calculations currently used to formulate portions of the monitoring report contain different criteria than those described in the manual, and current monitoring reports contain 13 extra fields not defined in the manual (see Chapter 2 for additional details).

Recommendations

The Department should:

- Consistently examine institutions in accordance with its rules and Department policies.
- At a minimum, rotate examiners in charge across institutions and, when possible, rotate all examiners periodically across institutions to help ensure examiner independence both in appearance and in fact.
- Independently verify that examiners possess credentials, including commissions, at the time of hire.
- Expand its training database to capture the number of training hours attended, and monitor employees for compliance with its training policies and procedures.
- Require employees to periodically disclose any actual or perceived conflicts of interest, such as current or past business activities or relationships in the mortgage lending, consulting, or banking industry; outside employment; or personal investments. If employees do not believe they have any actual or perceived conflicts of interest, they should document this in a disclosure statement.
- Periodically review all policies and procedures (including its *Supervisory Manual*) to ensure they reflect current Department practices, include all

previous revisions, and show correct revision dates throughout. In addition, the Department should fully incorporate its changes throughout the text to ensure that its policies are applied by all individuals consistently as intended by management.

Management's Response

The Department is in general agreement with the above recommendations and commits to expand the scope of written policies and reconcile conflicting statements that led to the majority of these recommendations. More than a decade ago the Department chose to abandon independent examination policies in favor of the FDIC's manuals. This decision was made in light of the extensive documented resources available through FDIC, examiner training provided to our staff by the FDIC and for consistency, as we perform all of our examinations jointly with the FDIC. However, the audit has disclosed two specific shortcomings for which we would need to supersede this practice. The first relates to inconsistencies between our agency's agreements with other state agencies and FDIC policies. The second relates to an instance where the FDIC did not update its policy to be consistent with federal law. We have already modified our policy position to allow superseding the FDIC policy in instances of conflict such as these two cases.

As to the specific recommendation within this chapter the department offers the following clarifications:

Recommendations

- ***Consistently examine institutions in accordance with its rules and department policy.***

We disagree with the results of this finding, although we understand the application of this audit procedure, and as stated below have already made the policy adjustments necessary to correct. The SAO findings state six instances of noncompliance with 18-month examinations, or 12-month examinations or examinations of newly chartered institutions within the first twelve months of operation. Half of the findings in this recommendation are the result of our adoption of FDIC policies as our guidance and the FDIC not changing its own policy to meet changes in federal law. Our actions related to 12-month examinations are fully compliant with federal law and our interagency performance measures.

The department has always managed examination scheduling in accordance with our performance measures as defined by the Legislative Budget Board (LBB) and reported those results quarterly. Only one of the cited exceptions is valid under these criteria. This exception for extending an examination beyond its due date was to conserve department resources and allow the sale

of the bank. The bank was merged out of existence just 31 days past its 18-month measure.

The final category is not meeting the limited examination of newly chartered institutions within the first six months. Using the LBB performance measure the department relies on, there were two instances, not four, and the average number of days past due is 22 days. There are always the pressures of coordinating joint examinations schedules with the FDIC and matching FDIC resources, human and otherwise, with ours. This resulted in one visitation being delayed by six days. With de novo institutions that have only been open for six months there is the added constraint of obtaining current quarter end Call report data that may also enter into a justified delay to allow pertinent data for review. This was the case for the other visitation that was delayed 39 days, but began on the very first day that its second ever Call report was filed.

ACTION: Completed. The department amended its policy for the blanket adoption of FDIC examination guidance to allow for well defined and documented variances. In this particular case our policy states we will comply with federal law when it conflicts with FDIC policy for examination cycles and when performance measures established for us by another state agency or the Finance Commission are in conflict with the FDIC policy the interagency definition will supersede.

- **At a minimum rotate examiners in charge across institutions and, when possible, rotate all examiners periodically across institutions to help ensure examiner independence both in appearance and in fact.***

We agree with this finding. The audit uses as its basis for criticism the FDIC policy as quoted in this report. The quote focuses strictly on the rotation of examiner-in-charge (EIC) and not on the staffing of team. Due to the number of depository institutions and limited staff size of safety and soundness examiners, there will always be a limited rotation of team members. As to the role of EIC not rotating, one examiner is cited as serving three out of four years as EIC. It is FDIC policy that is being quoted on this particular institution; however, the FDIC had the same examiner serve as EIC in all four of those years. Three other instances were brought to our attention as supporting this finding but are not specifically detailed in the report. In one of these instances we had the same EIC two years, but for that same institution the FDIC had the same EIC for three years. In another instance we had an examiner serve as a practice EIC but not responsible for the report or signing it and then as EIC the following year. In both examinations the FDIC had the same EIC.

ACTION: Limited. The department acknowledges the policy for rotation of EIC and will strive to meet this goal going forward. However, only limited rotation of entire examination staff will be possible. As the finding lists as its goal “independence in appearance and in fact” credit should be given for

every examination by the department being performed jointly with the FDIC. This structure provides a built in level of control over abuse of position. To totally rectify the finding of lack of independence would require co-opting two joint EICs from different agencies, subject to separate report and personnel review and supervision.

- ***Independently verify that examiners possess credentials, including commissions, at the time of hire.***

We agree with this finding. As pressures have increased in the financial markets, the department has responded by hiring experienced staff. Fortunately, we have been able to identify and recruit individuals with whom the department has had firsthand working relationships, while they were federal employees and examining institutions with us. For these individuals working in such capacity would have been impossible without the proper credentials.

ACTION: Completed. The department acknowledges this shortcoming and appreciates the report's statements that corrective action was immediately initiated. To the extent possible additional supporting documentation will be obtained on individuals already hired and future practice will be in compliance with the recommendation.

- ***Expand its training database to capture the number of training hours attended, and monitor employees for compliance with its training policies and procedures.***

We agree with this finding. Through changes in personnel the training coordinator duties were split and shifted and documentation although retained was not maintained in a single consistent source. The department has provided over 40 hours of in-house training to our staff in each of the years reviewed by the audit and therefore could certify internally that our policy was met. In less than one business day following a discussion of this finding the department provided a detailed history of each examiners classroom work with the corresponding hours. We are very pleased to report that each of our three junior safety and soundness examiners has each individually received in excess of 650 hours of training during the review period of the audit and all examiners have received at least 40 hours of training.

ACTION: In process. During the audit the department gathered the missing information and will have the new database consolidated under one individual within 30 days the issuance of this report.

- ***Require employees to periodically disclose any actual or perceived conflicts of interest, such as current or past business activities or relationships in mortgage lending, consulting, or banking industry; outside employment; or personal investments. If employees do not believe they have any actual or perceived conflicts of interest, they should document this in a disclosure statement.***

The Department already requires that employees acknowledge annually reading and complying with multiple agency policies, including conflict of interests and outside employment and financial interests policies by signing a receipt form, which is filed in each employee's personnel file. The outside employment and financial interests policy calls for disclosure of all outside business activities (paid or unpaid) and financial interests.

ACTION: In process. The current acknowledgement form will be expanded to allow employees to document non-existence of actual or perceived conflict of interests. The new form will be made available to all employees with the next round of annual reaffirmations in September, 2009.

- ***Periodically review all policies and procedures (including its Supervisory Manual) to ensure they reflect current Department practices, include all previous revisions, and show correct revision dates throughout. In addition, the Department should fully incorporate its changes throughout the text to ensure that its policies are applied by all individuals consistently as intended by management.***

We agree with this finding. The Department will amend its practice of capturing non-substantial policy amendments through a controlling cover sheet and will incorporate changes into the document itself.

ACTION: In process. The fully amended policy will be completed within 30 days the issuance of this report.

The Department Should Strengthen Controls Over Its Information Technology

Although the Department has implemented controls to protect its information technology resources, it should strengthen certain controls in this area. Control weaknesses resulted in inaccuracies in 12 of 16 quarterly monitoring reports that auditors tested.

The Department should strengthen controls over its monitoring report processes.

The Department has established controls and tools to assess the financial condition of institutions; however, controls over its monitoring report processes should be strengthened.

The Department uses a Financial Management Program (FMP) database application to store information from the call reports that institutions submit. The Department then uses the FMP database to produce key ratios and analysis in the form of a monitoring report. The monitoring report is crucial to the Department's monitoring process because it provides early indications of an institution's financial position.

However, control weaknesses resulted in inaccuracies in 12 of the 16 quarterly monitoring reports that auditors tested. Specific weaknesses identified included the following:

- While the folder containing the FMP database has limited access rights, the database itself is not protected with a password, and all users with access to the FMP database have administrative rights to that database. Implementing the FMP database's access right capabilities would help to ensure the integrity of the data.
- Data entry into the FMP database is not automated, and staff must enter data manually. While the database does include limited edit checks, these edit checks do not eliminate all data entry errors. Auditors reviewed a total of 255 FMP database fields for calendar years 2007 and 2008 and determined that 152 (60 percent) had some type of data error. The Department analysts who are responsible for the FMP database and producing the monitoring reports verify the data in the FMP database against the data in the FDIC's automated system only if a question arises.
- The FMP database is unable to calculate key ratios the Department needs to monitor call reports submitted by institutions. To force its FMP database to calculate key reporting ratios for these institutions, the Department "plugs" \$1 in applicable quarters and fields. However, the FMP database is represented in thousands of dollars; therefore, the

Department's plug of \$1 represents \$1,000, which could have a material effect on the results of a calculation.

- The Department does not have a sufficient change control process for its FMP database queries. Title 1, Texas Administrative Code, Section 202.25(7)(E), recommends that state agencies establish a process for controlling modifications to hardware, software, firmware, and documentation to ensure that information resources are protected against improper modification before, during, and after system implementation. Without a documented, formal change control process, key components of query language may not be performed or documented properly. This could result in errors that may not be readily detectable or traceable.

To produce quarterly monitoring reports, the Department relies on a series of intricate, and often embedded, queries that the Department must update each quarter. To update these queries, that Department copies queries from quarter to quarter and then manually updates them. There is no documented review of the updates. Auditors reviewed the queries used for eight quarters and determined that one query was not successfully updated for calendar year 2007. This error affected 104 individual calculations, 67 of which were inaccurate. Examples of the erroneous calculations included the calculation for average quarterly assets, which produced inaccurate results for 27 institutions for three quarters.

In addition, the above queries contain eight obsolete call report fields, seven of which had been obsolete since March 2001.

- The FMP database queries do not fully calculate in accordance with the Department's *Supervisory Manual*. Therefore, the monitoring report produced from these queries does not fully comply with the *Supervisory Manual*. In addition, because several of the report fields are created with circular references, an error in one field can lead to other errors throughout the entire report.

While these weaknesses were identified in the Department's current controls, the Department has decided to outsource the data collection and reporting function. When the Department outsources the data collection and reporting function, it will still need to take measures to ensure the accuracy of its data.

Recommendations

The Department should:

- Limit access rights to its FMP database so that staff entering data and using the report function have access only to the areas needed to fulfill their current job duties.

- Ensure the accuracy of any report used in the monitoring process by implementing either of the following:
 - ♦ Consider electronic methods of obtaining call report data, including downloading the data electronically, as long as the FMP database is in place. At a minimum, the Department should (1) perform a reconciliation of data entered with call report data to ensure that all key fields agree with the original source data and (2) implement a change control process that complies with Title 1, Texas Administrative Code, Section 202.25, to ensure that all FMP database updates and changes are reviewed and to ensure they are operating correctly.
 - ♦ Independently ensure that any reports resulting from outsourced services present accurate financial information. This may include requiring Department employees to perform sufficient testing of service providers' automated systems.
- Ensure that any report used as a monitoring tool complies with the Department's *Supervisory Manual* and that the manual reflects current practices for the data collection and reporting functions.

Management's Response

The Department agrees with the recommendations and will ensure their compliance in general terms. However, during the audit the Department entered into a contract and paid a third party for the outsourcing electronic data capture, data base management, and access to analytical software. Department staff also received training during the audit and the FMP model will no longer be utilized.

***ACTION:** In process. The Department will strive to implement the recommendations as they apply to the newly instituted financial information process.*

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

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

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

Scope

The scope of this audit included activities related to the Department's monitoring and examination of institutions from August 1, 2005, through March 31, 2009.

An audit scope limitation existed for determination of whether the Department monitors the safety and soundness of state-chartered savings banks, and whether the Department oversees the savings banks identified as having a poor or deteriorating financial condition. The Department conducts its examinations with the Federal Deposit Insurance Corporation (FDIC), and the FDIC did not permit the State Auditor's Office to access FDIC information and data. See Appendix 2 for details on the scope limitation.

Methodology

The audit methodology included review of applicable laws, statutes, rules, regulations, and Department policies and procedures; analysis of data from Department information systems; review of examiner personnel and training files; review of Department institution examination dates; and interviews with Department employees and management.

Information collected and reviewed included the following:

- FDIC rules and regulations.
- Title 12, Code of Federal Regulations, Chapter III.
- Texas Finance Code.
- Texas Administrative Code.

- The General Appropriations Act (80th Legislature).
- *Best Practices in Carrying Out a State Regulatory Program*, National State Auditors Association, 2004.
- Conference of State Bank Supervisors' accreditation program best practices.
- The Federal Financial Institutions Examination Council's (FFIEC) Consolidated Reports of Condition and Income.
- Department policies and procedures.
- Department Financial Management Program (FMP) database.
- Department documentation of examiner training and policy acknowledgements.
- Department examination logs, schedules, submittal letters, and travel vouchers.

Procedures and tests conducted included the following:

- Testing of examiner independence for compliance with Department policies and to ensure that Department policies are consistent with current industry best practices.
- Testing of examiner training documentation for compliance with all applicable laws, rules, and Department policies on employee training.
- Analysis of Department examination logs, schedules, and submittal letters to determine compliance with laws, rules, and regulations for examination timeliness.
- Analysis of Department examination logs, schedules, and submittal letters for evidence of examiner rotation.
- Comparison of the database the Department uses to produce quarterly monitoring reports with the FFIEC's Consolidated Reports of Condition and Income.
- Interviews with Department employees involved in institution examinations and review.
- Verification of examination dates through review of examiners' travel vouchers.

Criteria used included the following:

- FDIC rules and regulations.

- Title 12, Code of Federal Regulations, Chapter III.
- Texas Finance Code, Chapters 11, 13, 66, and 96.
- Title 7, Texas Administrative Code, Chapters 64 and 79.
- The General Appropriations Act (80th Legislature).
- *Best Practices in Carrying Out a State Regulatory Program*, National State Auditors Association, 2004.
- Conference of State Bank Supervisors' accreditation program best practices.
- Department policies and procedures.

Project Information

Audit fieldwork was conducted from March 2009 through June 2009. 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. Except for the aforementioned scope limitation, 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:

- Mary Ann Wise, CPA, CFE (Project Manager)
- Robert Pagenkopf (Assistant Project Manager)
- Thomas Andrew Mahoney
- Kamal Malik, CPA
- Anthony W. Rose, MPA, CPA, CGFM
- Kristyn Scoggins
- Joseph Kozak, CPA, CISA (Information Systems Audit Team)
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- Dennis Ray Bushnell, CPA (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)

Detailed Information on the Audit Scope Limitation

Government Auditing Standards, July 2007 Revision, Section 7.09, specifies that the scope of an audit defines the subject matter that the auditors will assess and report on, such as a particular program or aspect of a program, the necessary documents or records, the period of time reviewed, and the locations that will be included.

A scope limitation is a circumstance beyond an auditor's control that prevents the auditor from reaching conclusions about a function of the organization being audited. *Government Auditing Standards*, July 2007 Revision, Section 8.11, requires auditors to report significant constraints imposed on the audit approach by information limitations or scope impairments, including denials of access to certain records.

The institutions the Department of Savings and Mortgage Lending (Department) regulates are subject to Federal Deposit Insurance Corporation (FDIC) regulations. As a result, all evidence of the Department's examinations, enforcement, and many of its monitoring activities is restricted under federal regulations. On March 11, 2009, the State Auditor's Office requested access to this evidence from the FDIC under Title 12, Code of Federal Regulations, Section 309.6(3). On April 7, 2009, the FDIC informed the State Auditor's Office that auditors would not be permitted to access that information (see the FDIC's letter at the end of this appendix). On April 24, 2009, the State Auditor's Office made additional requests under Title 12, Code of Federal Regulations, Section 309.6(b)(6), to further clarify that the audit scope and objectives were intended to pertain only to the Department.³ As of July 2009, the FDIC had not approved or denied those requests.

Additionally, on April 24, 2007, the Department entered into a Cooperative Examination Program Agreement with the FDIC. That agreement stated that documentation related to bank examinations will not be released to any other individual by either agency without the written permission of the examining agency.

The State Auditor's Office is reporting a scope limitation because auditors were denied access to certain records and could not determine whether the Department complied with applicable statutes, administrative rules, and agency policy in overseeing the institutions identified as having a poor or deteriorating financial condition. The scope limitation existed primarily because auditors could not review information regarding the Department's monitoring activities and, as a result, auditors could not determine whether the Department complied with applicable statutes, administrative rules, and

³ The State Auditor's Office sent two separate letters on April 24, 2009: one to the FDIC's regional council for litigation and receivership operations and another to the FDIC's regional office in Dallas.

agency policy in monitoring the safety and soundness of institutions. Auditors also could not determine the financial condition of the institutions the Department regulates.

To make the determinations discussed in the preceding paragraph, auditors would have needed to review evidence supporting the examinations the Department performed, the decisions the Department made based on the outcome of those examinations, other documentation supporting the Department's monitoring activities, and the decisions the Department made based on its monitoring activities. However, auditors were unable to determine whether:

- The Department's conclusions in its *Reports on Examinations* were supported and had undergone appropriate levels of review.
- The Department's examinations were complete, performed in accordance with Department policy, adequately supported, and reflected the appropriate levels of review.
- The Department documented, supported, and reviewed changes to institution ratings.
- The Department's supervisory actions were consistent with *Reports on Examinations*, conducted in accordance with Department policy, documented, supported, and reviewed.
- The responses that institutions submitted to supervisory actions (quarterly progress reports) were submitted in a timely manner, reviewed by the Department, addressed the action, and contained all required submissions.
- The Department responded to institutional progress reports consistently, in a timely manner, and in accordance with Department policy.
- The Department's limited scope examinations (follow-up visits) that resulted from supervisory actions occurred in a timely manner, addressed the supervisory actions, were complete and in accordance with Department policy, were adequately supported, and reflected the appropriate levels of review.
- The Department reviewed institutions' independent audit reports, conducted these reviews in accordance with Department policy, and responded appropriately when necessary.

The Department conducts its examinations with the FDIC and, as discussed above, the FDIC did not permit the State Auditor's Office to access FDIC information and data (see the FDIC's letter on the next page).



Federal Deposit Insurance Corporation
Dallas Regional Office
1601 Bryan Street, 37th Floor, Dallas, Texas 75201
(800) 568-9161 FAX (972) 761-2164

Legal Division
Memphis Area Office
5100 Poplar Avenue, Suite 1900, Memphis, Tennessee 38137
(901) 685-1603 FAX (901) 821-5307

April 7, 2009

Regular Mail

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

RE: Access to FDIC Exempt Information - Part 309 Request
Texas Department of Banking/Texas Department of Savings and Mortgage
Lending

Dear Mr. Keel:

This letter is in response to your letter dated March 11, 2009, to Regional Director Thomas Dujenski, seeking access to certain records or information that have been provided by the Federal Deposit Insurance Corporation ("FDIC") to either the Texas Department of Banking or the Texas Department of Savings and Mortgage Lending (collectively referred to as "Department"). The records sought by the Texas Auditor's Office, more fully described below, are records that are confidential and can only be disclosed in accordance with Part 309 of the FDIC Rules and Regulations, 12 C.F.R. Part 309.

While the FDIC has limited authority to make discretionary disclosure of, or in this case allow a third party access to review, exempt information pursuant to 12 C.F.R. Part 309¹, Reports of Examination and related material will not be disclosed without a substantial showing of good cause. Thus, we reviewed your request and evaluated your stated reasons for seeking permission to disclose the documents described below, applied and evaluated the regulatory criteria as they relate to the request and weighed the various competing interests involved.² At the conclusion of this evaluation, the FDIC determined that good cause justifying disclosure of

¹ See in particular 12 C.F.R. § 309.6(b)(6) for specific instances when disclosure of exempt records or information to a third party is authorized under the regulation. See also 12 C.F.R. § 309.5(g)(8) for a definition of exempt records and/or information.

² Your request seeks discretionary disclosure under Section 309.6(3) of Title 12. I was unable to locate this section but it appears you are citing language under 12 C.F.R. § 309.6(b)(5). This section is not applicable to a State Auditor's Office as the authorization to release confidential exempt information is to an agency that supervises a "... a bank data center servicer, a depository institution service corporation or any other data center that provides data processing or related services to an insured institution...". Your request does not state that you are seeking information regarding the supervision of one of these entities.

certain of the confidential records has not been demonstrated.³

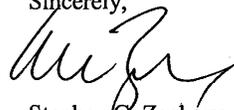
You seek access to the following types of documents: Reports of Examination, entity responses, work papers, enforcement orders, progress reports relating to enforcement orders, department responses to progress reports, work papers resulting from enforcement order site visits, exam and enforcement site visit schedules, and correspondence related to the aforementioned documents. All of the documents described above, except enforcement orders, are considered to be exempt records as defined by the regulation and can only be disclosed in accord with Section 309.6(b) of the regulation. To authorize discretionary disclosure of the aforementioned described exempt information to a third party, such as a State auditor's office, pursuant to 12 C.F.R. Part 309 there must be a substantial showing of good cause as set forth in subsections of 309.6(b)(6) of the regulation. 12 C.F.R. § 309.6(b)(6).

The FDIC's analysis of a depository institution's books and records is for regulatory and supervisory purposes and is not intended to be available to State auditors. To maintain a free flow of information depository institutions must be assured that the information provided to regulators will be kept strictly confidential. Examiners must be assured that their candid opinions regarding a depository institution are not used beyond the regulatory purposes for which they are prepared.

The Request Letter did not demonstrate the required showing of good cause to allow access to the confidential records and/or information requested, except enforcement orders issued by the FDIC which are not confidential and can be found on our website (or can be provided to your office by either Department).

Should you have any questions about the FDIC's position in this matter, please contact Senior Attorney Martin Silver at 972-761-2570.

Sincerely,



Stephen E. Zachary
Regional Counsel

³ This response only applies to FDIC "exempt information" or information derived from FDIC materials.

The Texas Finance Commission

The Texas Finance Commission (Commission) was created in 1943 to act as the policy making body for the Department of Banking, the Office of Consumer Credit Commissioner, and the Department of Savings and Mortgage Lending.

The Commission's mission is to ensure that the banks, savings institutions, consumer credit grantors, and other regulated entities chartered or licensed under state law operate as sound and responsible institutions that enhance the financial well-being of the citizens of Texas.

The Commission includes a nine-member panel appointed by the Governor and confirmed by the Senate. Members include one banking executive, one savings and loan executive, one consumer credit executive, one mortgage broker executive, and five public members. Table 1 lists the members of the Commission as of June 2009.

Table 1

| Texas Finance Commission Members as of June 2009 | | |
|---|------------------|-------------------|
| Commission Member | End of Term | Hometown |
| W.J. (Bill) White, Chair (Consumer Credit Executive) | February 1, 2010 | Georgetown, Texas |
| Mike Bradford (Public Member) | February 1, 2012 | Midland, Texas |
| Darby Byrd (Savings Executive) | February 1, 2012 | Orange, Texas |
| Riley Couch (Banking Executive) | February 1, 2012 | Frisco, Texas |
| Stacy London (Mortgage Broker Executive) | February 1, 2014 | Houston, Texas |
| Cindy F. Lyons (CPA/Public Member) | February 1, 2010 | El Paso, Texas |
| Lori B. McCool (Public Member) | February 1, 2014 | Boerne, Texas |
| Jonathan Bennett Newton (Public Member) | February 1, 2010 | Houston, Texas |
| Paul Plunket (Public Member) | February 1, 2014 | Dallas, Texas |

Source: The Texas Finance Commission Web site at www.fc.state.tx.us.

Institutions the Department of Savings and Mortgage Lending Regulates

As of December 31, 2008, the Department of Savings and Mortgage Lending (Department) regulated 28 institutions. Those institutions are listed in Table 2.

Table 2

| Institutions the Department Regulated As of December 31, 2008 | |
|--|-------------------------|
| Institution | Location |
| Capital Bank, S.S.B. | El Paso, Texas |
| Colorado Valley Bank, S.S.B. | La Grange, Texas |
| Equity Bank, S.S.B. | Dallas, Texas |
| Fayette Savings Bank, S.S.B. | La Grange, Texas |
| First Federal Bank Littlefield, Texas, S.S.B. | Littlefield, Texas |
| First Star Bank-Bremond, S.S.B. | Bremond, Texas |
| Founders Bank, S.S.B. | Sugar Land, Texas |
| Horizon Bank, S.S.B. | Austin, Texas |
| Independent Bank of Austin, S.S.B. | Austin, Texas |
| Integrity Bank, S.S.B. | Houston, Texas |
| Interstate Bank, S.S.B. | Perryton, Texas |
| Libertad Bank S.S.B. | Austin, Texas |
| Lone Star Bank, S.S.B. | Moulton, Texas |
| Mineola Community Bank, S.S.B. | Mineola, Texas |
| NexBank, S.S.B. | Dallas, Texas |
| Oasis Bank, S.S.B. | Houston, Texas |
| Orange Savings Bank, S.S.B. | Orange, Texas |
| Pioneer Bank, S.S.B. | Dripping Springs, Texas |
| Providence Bank of Texas, S.S.B. | Southlake, Texas |
| Shelby Savings Bank, S.S.B. | Center, Texas |
| Spirit of Texas Bank, S.S.B. | College Station, Texas |
| Synergy Bank, S.S.B. | McKinney, Texas |
| Texas Exchange Bank, S.S.B. | Crowley, Texas |
| Texas Savings Bank, S.S.B. | Snyder, Texas |
| Texas Star Bank, S.S.B. | Lott, Texas |
| The Bank and Trust, S.S.B. | Del Rio, Texas |
| Third Coast Bank, S.S.B. | Humble, Texas |
| TrustTexas Bank, S.S.B. | Cuero, Texas |

Source: Federal Deposit Insurance Corporation.

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. Mike Bradford
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 Savings and Mortgage Lending

Mr. Douglas B. Foster, Commissioner



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