State
Auditor's
Office

**John Keel, CPA**
**State Auditor**

An Audit Report on

# The Department of Banking

July 2009

Report No. 09-043

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## *Overall Conclusion*

Overall, the Department of Banking (Department) complies with applicable statutes, administrative rules, and Department policy in monitoring the safety and soundness of state-chartered commercial banks and overseeing the commercial banks identified as having a poor or deteriorating financial condition.

**Background Information**

The Department of Banking (Department) supervises and regulates all state-chartered banks in Texas. As of March 31, 2009, the Department regulated 325 state-chartered banks. See Appendix 2 for an overview of the Texas banking industry.

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 180 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.

However, the Department has been unsuccessful in conducting all of its bank examinations in a timely manner in accordance with Department policy. Six (46 percent) of 13 examinations that auditors tested were conducted an average of 26 days late. It is important to note that none of these 6 examinations was for a bank with a rating of 3, 4, or 5. (Bank ratings range 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.) According to Department management, the Department conducted these examinations late due to a lack of experienced examiners. The Department's goal is to employ 56 commissioned examiners, but it employed only 24 commissioned examiners as of March 11, 2009. The Department also employed 52 non-commissioned examiners, 65 percent of whom are eligible to begin the commissioning process.

The 81st Legislature appropriated $6.3 million to the Department for the 2010-2011 biennium for 14 new senior bank examiner positions and for bank examiner retention and competitive salaries. In addition, House Bill 2774 (81st Legislature) transformed the Department, the Office of Consumer Credit Commissioner, the Department of Savings and Mortgage Lending, and the Credit Union Department into self-directed and semi-independent agencies effective September 1, 2009. The bill removed the agencies from the legislative budgeting process, and each agency's budget will be adopted and approved only by the policy-making body of the agency. The bill also requires the State Auditor's Office to contract with each agency to conduct financial and performance audits.

A limitation on the scope of this audit prevented the State Auditor's Office from fully determining without qualification whether the Department is performing its monitoring duties. Because the Department has cooperative agreements with the Federal Deposit Insurance Corporation and the Federal Reserve Bank, the State

*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.*

Auditor's Office was required to request access to information that the agreements determined was confidential. The Federal Reserve Bank granted the State Auditor's Office conditional access to the confidential information for the banks for which the Federal Reserve Bank is the lead oversight entity. However, the Federal Deposit Insurance Corporation did not permit the State Auditor's Office to access information necessary to address the objectives of this audit. The denial of access to certain records limited the scope of this audit.

The Department ensures that its bank examiners are adequately trained, independent, and evaluated. Based on the administrative and enforcement actions auditors reviewed, the Department complies with applicable statutes, administrative rules, and agency policy in overseeing banks with a poor or deteriorating financial condition. The Department also has been accredited by the Conference of State Bank Supervisors' Performance Standards Committee since October 1993, and it has continued to meet the standards of the accreditation program and comply with that program's policies and goals.

Auditors identified opportunities for the Department to strengthen controls in areas such as ensuring that the Department processes examination reports in a timely manner, updates its training policy to reflect current practices, submits exception monitoring results to the Department's Director of Bank and Trust in a timely manner, and ensures that its consistently contacts banks within required time frames between examinations.

## *Summary of Management's Response*

The Department agreed with the recommendations in this report.

## *Summary of Information Technology Review*

The Department has adequate and effective general information technology controls and application controls to ensure the integrity of bank examination data.

User access to the Department's bank examination tracking system is appropriately limited to users whose job responsibilities require them to access that system.

## *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 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. A limitation on the scope of this audit was discussed above.

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; analyzing examiner hiring and training policies; evaluating the results of testing and observations; and reviewing database controls.

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## Detailed Results



## Appendices

# *Detailed Results*

*Chapter 1*

## *Overall, the Department Complies with Requirements for Examinations, and Its Examiners Have Sufficient Training and Experience*

Overall, the Department of Banking (Department) performs state-chartered bank examinations in accordance with applicable statutes, administrative rules, and Department policy. However, the Department should make improvements in processing examination reports in a timely manner.

The Department's examiners have the experience and training necessary to effectively monitor the safety and soundness of state-chartered banks. As of March 11, 2009, the Department employed 76 bank field examiners who were responsible for monitoring the safety and soundness of commercial banks. However, examiner staffing levels are imbalanced and there are significant differences in experience levels among examiners and across the Department's regional offices. Of the Department's 76 examiners, 52 (68 percent) are not commissioned bank examiners and 24 (32 percent) are commissioned bank examiners. The Department's goal is to employ 56 commissioned examiners, but it has not been able to meet that goal. The 81st Legislature appropriated $6.3 million to the Department for the 2010-2011 biennium for 14 new senior bank examiner positions and for bank examiner retention and competitive salaries.

Chapter 1-A

### Overall, the Department Complies with Applicable Statutes, Administrative Rules, and Agency Policy Regarding Bank Examinations

The Department performs state-chartered bank examinations in accordance with applicable statutes, administrative rules, and Department policy. However, audit testing was restricted to the 35 state-chartered banks regulated by the Federal Reserve Bank and the Department. A limitation on the scope of this audit prevented auditors from fully determining without qualification whether the Department is performing its monitoring duties.

Auditors judgmentally selected 16 state-chartered banks regulated by the Federal Reserve Bank and the Department. The largest bank was excluded from the sample because it was not representative of the population. The 16 banks selected had $12.1 billion (88 percent) of the $13.8 billion in state-chartered member bank assets, excluding the largest bank, as of December 31, 2008. Auditors confirmed that the Department conducted the following procedures during its examinations of the 16 state-chartered banks tested:

**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.

- Analyzed investments.
- Reviewed loans for out-of state branch operations (if necessary).
- Reviewed high-risk loans.
- Properly documented and carried forward issues to the examination report.
- Assigned appropriate CAMELS ratings that were supported by the examination documentation.
- Ensured that proper authorities signed the examination reports.
- Ensured that its examiners were independent.

In addition, on an annual basis, the Department's Examiners' Council (EC) reviews randomly selected working papers from eight of the Department's bank examinations (two examinations from each of the four regional offices). The EC compiles a report of findings from its review and prepares a list of recommendations and guidelines to promote consistency across the regions and maintain high standards in the working papers. It classifies its findings as "critical," "important," and "technical." Critical findings are those that affect the report of examination with respect to any unrecognized loss, cause a change in the CAMELS rating, or result in missing commentary. The number of critical deficiencies the EC identified increased from 5 in 2007 to 7 in 2008; the deficiencies were identified in 6 of 8 bank examinations reviewed. However, overall the EC found in its 2007 and 2008 reviews that the examination working papers supported the examination findings and the completeness of the working papers was satisfactory.

The Department did not process examination reports within the required internal time frame for 6 (40 percent) of 15 bank examinations tested.[1] On average, the bank examination reports that were not processed in a timely manner were processed 16 days late. 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 that have total assets of less than $500 million. All other examinations are processed at Department headquarters. The Department's Director of Bank and Trust may grant an extension for processing an examination report, which should be documented in the Department's examination database.

The Department reports it is currently behind in its review of bank examinations due to an increase in the number of problem banks and understaffing in review examiner positions. Additionally, when a problem bank is identified, other organizations such as the Federal Reserve Bank and the Federal Deposit Insurance Corporation must become involved in the process, which increases examination report processing times.

Table 1 summarizes the frequency of bank examinations.

Table 1

| Frequency of Bank Examinations | | |
|---|---|---|
| **Value of Assets (In Thousands)** | **Composite CAMELS Rating and Capital Criteria** | **Examination Frequency** |
| More than $500,000 | Composite CAMELS rating of 1 or 2 | Every 12 Months |
| Less than $500,000 | Composite CAMELS rating of 1 or 2 and "well capitalized" as defined by Title 12, Code of Federal Regulations, Section 325.103 (b)(1) | Every 18 Months |
| Less than $500,000 | Composite CAMELS rating of 1 or 2, with a CAMELS rating of 3 for management practices | Every 12 Months |
| Any Size | Composite CAMELS rating of 3, 4, or 5 | Every 6 Months |

Source: Department of Banking.

[1] One of the 16 examinations was excluded from this test because the examination report had not been finalized as of the date of audit testing.

### Recommendation

The Department should improve its timeliness in processing examination reports to comply with the required internal policy.

### Management's Response

*The Department acknowledges and accepts the recommendation that examination reports need to comply with internal time frames for processing so that examination findings can be formally communicated back to the respective institutions within a timely manner. This process has been formally tracked and monitored for several years and continues to receive constant attention. The current policy was developed and predicated on a staffing plan of two review examiners at head quarters and an industry environment where the number of problem institutions equaled about 4% of the total institutions under supervision. A change in conditions has necessitated the application of additional resources in this area, but such changes have been slow to evolve due to competitive compensation disparities and the need to keep experienced financial examiners in the field leading on-site institutional reviews. Nevertheless, the staffing plan was adjusted in 2008 to increase the review staff, but turnover within its ranks has reduced efficiencies and effectiveness. Further and maybe more important, the number of problem institutions now approximates 12% of the total institutions under supervision and both of these factors has lead to report processing delays. Reports associated with problem institutions require more time to process due to developing and initiating administrative or enforcement regulatory responses, often coordinated with the federal regulatory agencies. To cure, the Department is in the process of utilizing qualified individuals out of the regional offices to assist in fulfilling the duties of the review examiners and a former examiner is scheduled to begin work in July 2009.*

Chapter 1-B

## Department Examiners Have the Experience and Training to Effectively Monitor the Safety and Soundness of State-chartered Banks, But the Department Has Not Met Its Staffing Goal for Commissioned Examiners

Auditors tested the experience and training of 30 bank examiners and identified no errors. From the results of that testing, auditors concluded that the Department ensures that its bank examiners are adequately trained, independent, and evaluated. As of March 11, 2009, the Department employed 76 bank field examiners who were responsible for monitoring the safety and soundness of commercial banks.

**The Commissioning Process for Examiners**

To be eligible for and prepare for the commissioning process, examiners undergo intensive training that lasts three to four years and includes on-the-job training, mentoring by experienced examiners, attendance at staff meetings and conferences, and instruction at a series of formal schools.

**Excerpt from the General Appropriations Act (80th Legislature)**

**4. Contingency Appropriations: State Regulatory Response.**

a. Amounts appropriated above to the Department of Banking not to exceed $5,550,432 each fiscal year in General Revenue in Strategy D.1.1, Contingency Regulatory Response, and 56.5 Full-Time-Equivalents (FTE) positions each fiscal year included above in the "Number of Full-Time-Equivalents (FTE)" are contingent upon a finding of fact by the Finance Commission that additional resources are needed by the Department of Banking because:

(1) the number of exams required for the state-chartered commercial banking industry under the jurisdiction of the Department of Banking, determined either as a function of assets, number of institutions, expanded specialty areas, or relative proportion of problem banks or problem bank assets in the state system, increases to a point where additional appropriations are required to maintain adequate regulation of the industry;

(2) federal regulatory resources applied to the Texas state-chartered commercial banking industry, determined as a function of assets, have been reduced; or

(3) the Department of Banking is unable to maintain adequate supervision of the industry and is unable to meet its examination frequency performance measures due to reductions in the quality or quantity of its examination staff, resulting either from examiner turnover, or an inability to recruit adequately qualified examiners because of salary levels.

Source: Rider 4, page VIII-7, General Appropriations Act (80th Legislature).

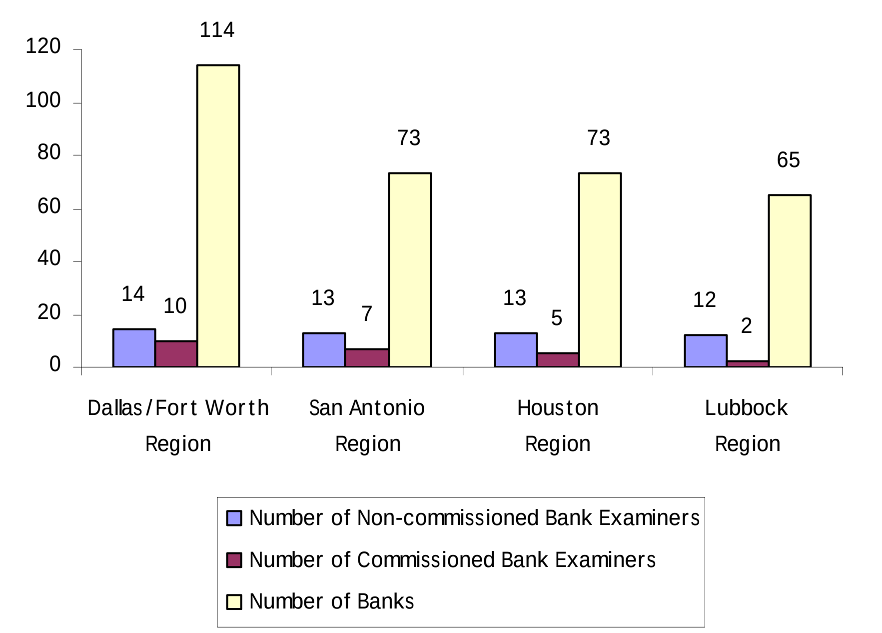
While Department examiners have the experience and training necessary to effectively monitor the safety and soundness of state-chartered banks, examiner staffing levels are imbalanced and there are significant differences in experience levels among examiners and across the Department's regional offices. Of the Department's 76 examiners, 52 (68 percent) are not commissioned bank examiners and 24 (32 percent) are commissioned bank examiners. The Department's goal is to employ 56 commissioned examiners, but it has not been able to meet that goal. However, 34 (65 percent) of the Department's 52 non-commissioned examiners are eligible to begin the commissioning process.

In February 2009, the Department requested the activation of its "regulatory response rider" to hire additional experienced examiners due to an increase in the number of problem banks (see text box for additional details). The Department received approval to hire seven experienced examiners for fiscal year 2009. The 81st Legislature appropriated $6.3 million to the Department for the 2010-2011 biennium for 14 new senior bank examiner positions and for bank examiner retention and competitive salaries.

The Department has regional offices in Dallas/Fort Worth, Houston, San Antonio, and Lubbock. As Figure 1 on the next page shows, 10 (42 percent) of the Department's 24 commissioned examiners are in Dallas/Fort Worth, 7 (29 percent) are in San Antonio, 5 (21 percent) are in Houston, and 2 (8 percent) are in Lubbock. Considering the relatively low number of commissioned bank examiners, the distribution of commissioned bank examiners across regional offices is reasonably well balanced. The San Antonio and Houston regional offices each monitor 73 commercial banks; San Antonio has 7 commissioned bank examiners, while Houston has 5. Because the Department projects that the most significant bank deterioration will occur in the Dallas/Forth Worth and Houston areas, the Houston regional office could benefit from having additional commissioned bank examiners.

Figure 1

**Number of Examiners and Banks by Department Regional Office**
**As of March 11, 2009**




Source: Department of Banking.

The Department has established the following examiner employment and training processes and procedures:

- Documented hiring procedures and internal policies that clearly define minimum education and experience levels required.
- A documented performance management system to annually evaluate examiners based on an assessment of critical job factors that clearly identify areas in which the examiner is performing well and areas that need improvement.
- An examiner training and commissioning process that is highly detailed and designed to ensure that examiners maintain and improve their competencies to monitor the safety and soundness of commercial banks.

- A mechanism called the "Dance Card" to monitor the progress and proficiency of examination procedures performed by new examiners. The Department uses this mechanism to ensure that new examiners are continuously assigned different procedures so that they will attain the level of knowledge and skills needed for the commissioning process.

However, auditors identified opportunities for improvement in examiner training. For example, the Department should update its training policy to reflect its practices. Specifically:

- The policy separates bank operations and bank financial analysis into two distinct core curriculum courses required for examiners, and it does not specify that these curriculum courses have been combined into a certified operations examiner school.
- Although the training policy shows five courses required before promotion to the level of Financial Examiner IV, the Department's current practice is to require four of the five courses.
- The Dance Card is a required training tool used to monitor assistant examiners' progress, but the training policy does not discuss the Dance Card.

These issues are important because Department management uses the training policy to communicate its directives for training requirements. When the Department's actual requirements are inconsistent with its training policy, this weakens the training policy as a control.

### Recommendation

The Department should update its training policy to reflect the actual training required.

### Management's Response

*The Department agrees with the SAO's findings and has amended its internal training policy to reflect the recommendations.*

# The Department Should Ensure That It Conducts the Examinations for Which It Is Responsible in a Timely Manner

The State Auditor's Office's access to bank examination information was restricted to the 35 banks regulated by the Department and the Federal Reserve Bank of Dallas. Auditors tested the timeliness of 34 bank examinations the Department conducted at those banks between January 1, 2006, and March 31, 2009. Auditors excluded the largest bank from audit testing because it was not representative due to its asset size.

The Department did not consistently conduct the bank examinations tested within the time limits required by its policy. Thirteen (38 percent) of the 34 examinations were the responsibility of the Department, and the Department conducted 6 (46 percent) of those 13 examinations late. These six examinations were conducted an average of 26 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. Two of the six late examinations were conducted 30 to 45 days after the scheduled due date. Four of the six late bank examinations were conducted fewer than 30 days after the scheduled due date.

The Department asserted that it conducted these examinations late because it is understaffed both in experience and in the number of examiners (see Chapter 1-B for more details). Additionally, the increase in problem banks results in examinations taking longer because the Department must bring other organizations such as the Federal Deposit Insurance Corporation and the Federal Reserve Bank into the examination process.

The Department's policy (which became effective September 30, 2008) states that the next examination date uses a "base date" that is the earliest of (1) 60 calendar days from the start date of the examination or (2) the completion date of the full scope examination as shown in the Department's Examination Division Information System on the Network (EDISON). For examinations conducted by the Federal Reserve Bank, the completion date is located on the report cover page and referenced as "date concluded." After the base date has been determined, the examination frequency cycle period (which is based on the CAMELS rating and asset size) is added to determine the next examination due date. Auditors determined timeliness for examinations that were due before September 30, 2008, by adding the examination frequency cycle to the examination start date.

### Recommendation

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

### Management's Response

*The Department agrees with the recommendation; however, the Department has not been able to recruit and retain a sufficient number of experienced and qualified examiners. As noted in this report, the Department is operating with 32 less commissioned examiners than required in the agency's staffing plan. This lack of examiner experience lowers production efficiency levels as less experienced examiners require more hours to perform on-site review procedures, more on-the-job instruction and closer output review to ensure the quality and integrity of their work. While the number of commissioned examiners has been increasing over the last two years, sufficient depth of examiner experience will remain a challenge for the next several years. Expenditure approval was recently obtained and employment opportunities have been posted for 14 Financial Examiner VII positions. Further, the Department is initiating a limited scope examination for low risk institutions that will reduce the amount of on-site review and report processing times. However, high risk institutions will continue to receive prompt and comprehensive examinations and oversight.*

*Chapter 3*

## *The Department Provides Sufficient Oversight of Commercial Banks Identified as Having a Poor or Deteriorating Financial Condition*

Based on the administrative and enforcement actions auditors reviewed, the Department complies with applicable statutes, administrative rules, and agency policy in overseeing banks with 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 these actions are appropriate, effective, and consistently applied.

**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.

Auditors' access to administrative and enforcement actions issued and active as of March 31, 2009, was limited to administrative and enforcement actions that were imposed on banks that are regulated by the Federal Reserve Bank. The Federal Deposit Insurance Corporation (FDIC) did not permit auditors to access information regarding the other administrative and enforcement actions issued and active for the banks that it regulates.

Auditors selected a sample of administrative and enforcement actions for banks regulated by the Federal Reserve Bank and identified no errors. The Department asserts that the same administrative and enforcement actions are used, regardless of whether a bank is overseen by the Federal Reserve Bank or by the FDIC.

### Management's Response

*The Department agrees with the SAO findings in this area.*

# *The Department's Ongoing Monitoring Program Provides Adequate Supervisory Attention to Banks With a High-risk Profile*

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

- An exception monitoring report.
- A bank watch list.
- A bank call program.
- Progress reports.
- 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.

State-chartered banks that are placed on an administrative or enforcement action are required to submit quarterly progress reports that indicate the efforts bank management has made to remedy the problems. Problem banks are placed on a quarterly "Bank Watch List" because these banks warrant close monitoring. The 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 in a timely manner, and these reports identified the banks' efforts to remedy problems. Auditors also verified that the Department placed problem banks on the quarterly watch list and the primary monitoring report until the banks resolve all issues. Auditors identified no errors during testing of administrative and enforcement actions; therefore, for the limited number of actions tested, auditors concluded that the Department's off-site monitoring program provides adequate supervision to 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 (6 percent) of 16 banks tested had a CAMELS rating that increased by more than one point since the previous examination, and Department management acknowledged that this was a result of the limitations of off-site monitoring. Specifically, the Department cannot determine deterioration in a bank's asset quality without conducting an on-site examination. The remaining 15 banks tested had CAMELS rating that remained within one point of their previous CAMELS ratings, which indicates that off-site monitoring tools are effective.

However, the Department should strengthen controls in the following areas:

- Although the Department contacts state-chartered banks between examinations, it does not always contact them within the required time frame for banks with CAMELS ratings of 1 or 2. For 7 (44 percent) of 16 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 7 banks 74 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.

- The Department's regional directors prepare Exception Monitoring Reports (EMR) that include an analysis of high-risk areas. EMRs are a useful off-site monitoring tool for banks that are rated 1 or 2. However, 1 (25 percent) of 4 EMRs for September 30, 2008, was submitted 17 days late. Submitting EMRs late to the Department's Director of Bank and Trust could result in a high-risk bank not being identified in a timely manner. Department management stated that this EMR was submitted late because the regional director who prepared the EMR is new in the position and because the regional office in which this individual is employed is understaffed.

### Recommendations

The Department should:

- Consistently contact banks within the first half of the examination cycle between examinations, if required.

- Ensure that regional directors consistently submit EMRs by the required due date.

### Management's Response

*Recommendation - The Department should consistently contact banks within the first half of the examination cycle between examinations, if required.*

*Response – This policy was initiated several years ago to contact bankers in a non-examination setting to discuss current regulatory topics and industry trends. The policy is not intended to assist in discovering early signs of increasing institutional risk. The program is beneficial in allowing bankers across the state to have periodic contact with Departmental personnel in a* *relaxed setting. Time parameters for these visits will be expanded to cover a multi-month range within the normal examination cycle. This will allow additional flexibility in arranging meaningful meetings with industry executives.*

*Recommendation – The Department should ensure that regional directors consistently submit EMRs by the required due date.*

*Response – The Department concurs with this recommendation and will ensure timely submission of these reports.*

Chapter 5

## The Department Has Adequate and Effective Controls Over Its Bank Examination Database and Appropriate Access Controls Over Its Imaging System

Information technology (IT) controls over the Department's bank examination database are adequate and effective. Auditors identified no weaknesses in controls over logical access, program changes, backup procedures, and disaster recovery.

The Department also has adequate and effective general IT controls and application controls, such as input controls, process controls, and output controls, to ensure the integrity of data used for testing bank examination data.

The Department's user access controls for its imaging system are appropriate. All examiner working papers are imaged in that system.

### Management's Response

*The Department agrees with the SAO findings in this area.*

# 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 policy 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 scope of this audit covered the period from January 2006 to March 2009. Auditors reviewed examinations of state-chartered banks, administrative and enforcement actions, bank examiner training/independence, Examiner's Council reports, and the off-site monitoring programs. A limitation on the scope of this audit prevented the State Auditor's Office from fully determining without qualification whether the Department is performing its monitoring duties. Because the Department has cooperative agreements with the Federal Deposit Insurance Corporation and the Federal Reserve Bank, the State Auditor's Office was required to request access to information that the agreements determined was confidential. The Federal Reserve Bank granted the State Auditor's Office conditional access to the confidential information for the banks for which the Federal Reserve Bank is the lead oversight entity. However, as of May 20, 2009, the Federal Deposit Insurance Corporation had not permitted the State Auditor's Office to access information necessary to address the objectives of this audit. This represented a limitation on the scope of this audit.

As of March 31, 2009, the Department reported it regulated 325 state-chartered banks. The Federal Reserve Bank was the federal oversight entity for 35 (11 percent) of the 325 state-chartered banks. The remaining 290 banks (89 percent) are under the federal oversight of the Federal Deposit Insurance Corporation, and auditors were not permitted access to those banks' examinations and reports.

Auditors also reviewed general controls and application controls over the Department's bank examination database. Auditors reviewed user controls over the imaging system.

## 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; analyzing examiner training policies; evaluating the results of testing and observations; and reviewing database controls.

Information collected and reviewed included the following:

- Policies and procedures for Department examinations, administrative and enforcement actions, off-site monitoring, training, and personnel.
- Bank examination reports, procedures, and working papers of state-chartered banks regulated by the Federal Reserve Bank and the Department.
- Conflict of interest statements, training, and performance evaluations for bank examiners.
- Department bank examiner experience levels and turnover information.
- Administrative and enforcement actions for banks regulated by the Federal Reserve Bank 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 Federal Reserve Bank and the Department.
- Bank CAMELS ratings in the bank examination database and CAMELS variance reports, if necessary.
- The Department's Examiner's Council annual review of commercial banks for fiscal years 2007 and 2008.
- Information regarding banks that received Troubled Asset Relief Program (TARP) funds and the affect on the Department.

Procedures and tests conducted included the following:

- Interviewed management and key staff at the Department.
- Reviewed and tested policies and procedures related to bank examiner independence, training, and performance evaluations.
- Analyzed bank examiners' experience levels and turnover.

- Reviewed and tested policies and procedures for bank examinations, administrative and enforcement actions, and the off-site monitoring program for banks regulated by the Federal Reserve Bank.
- Reviewed and analyzed the Department's Examiner's Council annual reports of commercial bank working papers for fiscal years 2007 and 2008.
- Determined the number of state-chartered banks that received TARP funds.
- Reviewed and tested general information technology and application controls over the Department's bank examination database and user controls over the Department's imaging system.

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 training, personnel, and bank examinations.
- Department examiner bulletin CL 2008-01.
- Best practices from the Conference of State Bank Supervisors' accreditation review.
- Uniform Financial Institution Rating System (CAMELS) rating system definitions.
- Texas Finance Code, Chapters 12, 31, and 35.
- Title 7, Texas Administrative Code, Sections 3.21, 3.36, 3.37, and 3.52.
- Department cooperative agreements with the Federal Deposit Insurance Corporation and the Federal Reserve Bank.

## Project Information

Audit fieldwork was conducted from March 2009 through May 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. 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)
- Frances Anne Hoel, CIA, CGAP
- Thomas Andrew Mahoney
- Tessa Mlynar
- Anca Pinchas, CPA
- Rachel Snell, CFE, MPAff
- Kimberly Teague, MS
- Gary Leach, CISA, CQA (Information Systems Audit Team)
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)

# Overview of the Texas Banking Industry and Its Oversight

The Finance Commission is responsible for overseeing and coordinating the Department of Banking, the Department of Savings and Mortgage Lending, and the Office of the Consumer Credit Commissioner. It serves as the primary point of accountability for ensuring that state depository and lending institutions function as a system. The Finance Commission is the policy-making body for those agencies and is not a separate state agency. The Commission appoints the commissioners of these three agencies.

The Finance Commission includes nine members who are private citizens. They are appointed by the Governor and are subject to Senate confirmation. Members serve overlapping, six-year terms. The Texas Finance Code requires the Finance Commission to include one state banker; one state savings and loan executive; one consumer credit executive; one mortgage broker; and five public members, one of whom must be a certified public accountant. The Governor appoints the presiding officer. The Commission is required to meet at least six times a year.

The Finance commission appoints one of the three agency commissioners as the executive director of the Finance Commission to facilitate the oversight of finance commission activities and shared resources of the three agencies.

The mission of the Department of Banking (Department) is to ensure that Texas has a safe, sound, and competitive financial services system. The Department does not license and regulate all financial service providers in Texas. The Department oversees certain types of financial services including banks, trust companies, money services businesses, perpetual care cemeteries, and pre-need funeral contract providers.

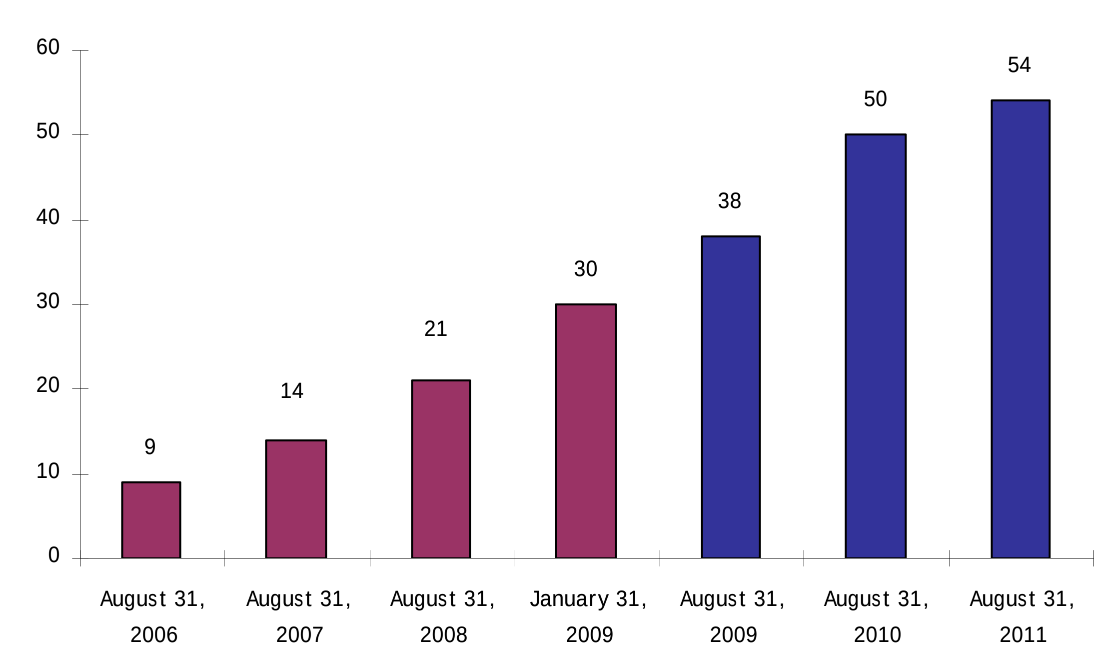
The Legislature reviewed and modified the Department's functions after a Sunset review in 2001. By statute, the Department is self-funding, self-leveling, and has no affect on the state budget. The Department's commissioner is authorized to impose and collect only fees (see Texas Finance Code, Section 31.106) established by the Finance Commission for the cost of examination, the equitable or proportionate cost of maintenance and operation of the Department, and the cost of enforcement. All of the Department's operating funds are generated from fees assessed on the businesses supervised by the Department and are used to fund both direct and indirect costs.

As of March 31, 2009, the Department reported it regulated 325 state-chartered banks. Eighty-eight percent of those banks were rated satisfactory or better, which means they had CAMELS ratings of 1 or 2.

Between December 31, 2008, and March 31, 2009, the number of problem banks the Department regulated increased from 24 to 33, a 37.5 percent increase.  The Department projects that the number of problem banks will increase to 54 by August 2011 (see Figure 2).

Figure 2

**Actual and Projected Numbers of Problem Banks in Texas** [a]




[a] The Department projected the number of problem banks for August 31, 2009, through August 31, 2011.

Source: Department of Banking.

On October 3, 2008, President Bush signed the Emergency Economic Stabilization Act of 2008, which established the Troubled Asset Relief Program (TARP), a $700 billion assistance program administered by the U.S. Department of the Treasury. On October 14, 2008, the U.S. Department of the Treasury announced a voluntary Capital Purchase Program. Under this program, the Treasury set aside $250 billion from the $700 billion appropriated under TARP to purchase senior preferred shares from qualifying financial institutions and holding companies.

As of March 31, 2009, 17 Texas state-chartered banks had received funding through the Capital Purchase Program for a total of $2,825,004,000, with one bank receiving about 80 percent of this amount (see Table 2).

Table 2

**State-chartered Texas Banks That Had Received TARP Funds as of March 31, 2009**

| Name of Bank | Headquarters | Amount of Funds Received | Date Bank Returned the Funds (if any) |
|---|---|---|---|
| Comerica Bank | Dallas | $2,250,000,000 | None returned as of March 31, 2009 |
| International Bancshares | Laredo | 216,000,000 | None returned as of March 31, 2009 |
| Sterling Bancshares | Houston | 125,198,000 | May 5, 2009 |
| Plains Capital | Dallas | 87,631,000 | None returned as of March 31, 2009 |
| Patriot Bancshares | Houston | 26,038,000 | None returned as of March 31, 2009 |
| Central Bancorp | Garland | 22,500,000 | None returned as of March 31, 2009 |
| Central Community | Temple. | 22,000,000 | None returned as of March 31, 2009 |
| Sovereign Bancshares | Dallas | 18,215,000 | None returned as of March 31, 2009 |
| First Texas BHC, Inc. | Fort Worth | 13,533,000 | None returned as of March 31, 2009 |
| Farmers & Merchants Bancshares | Houston | 11,000,000 | None returned as of March 31, 2009 |
| BOH Holdings | Houston | 10,000,000 | None returned as of March 31, 2009 |
| MS Financial, Inc | Kingwood | 7,723,000 | None returned as of March 31, 2009 |
| Central Bancshares | Houston | 5,800,000 | None returned as of March 31, 2009 |
| Treaty Oak Bancorp | Austin | 3,268,000 | None returned as of March 31, 2009 |
| Lone Star Bank | Houston | 3,072,000 | None returned as of March 31, 2009 |
| IBT Bancorp, Inc. | Irving | 2,295,000 | None returned as of March 31, 2009 |
| First State Bank of Mobeetie | Mobeetie | 731,000 | None returned as of March 31, 2009 |
| | **Total** | **$2,825,004,000** | |

Source: United States Treasury Office of Financial Stability Web site at http://www.financialstability.gov/docs/transaction-reports/transactionsReport052709.pdf.

A total of 60 banks in Texas have applied for these funds, including the 17 Texas-chartered banks that have received funds. The U.S. Department of the Treasury has not asked the Department of Banking to perform any specific monitoring functions related to TARP funds. The U.S. Department of the

Treasury and other federal agencies are still developing TARP reporting requirements.

## Conference of State Bank Supervisors Accreditation Program

The Conference of State Bank Supervisors' (CSBS) Performance Standards Committee sponsors a comprehensive state banking department performance accreditation program to encourage state banking departments to enhance their capability to promote safe and sound banking. It is a voluntary program. That committee reviewed the following areas at the Department of Banking (Department):

- Administration and finance.
- Personnel.
- Training.
- Bank examination policies and procedures.
- Ability to rate financial institutions, recognize problems, and initiate effective corrective procedures.
- Bank supervision.

The Department has been accredited by the CSBS since October 1993 and continues to meet the standards of that program and comply with that program's policies and goals.

The Department was reaccredited by the CSBS as a result of a February 2008 review.

The CSBS accreditation program is available to all 50 states and 4 territories. Forty-seven of the 54 states and territories are accredited, and the Department is ranked within the top 25 percent of accredited entities.

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. 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