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A Supplemental Audit Report on
**The Department of Savings and
Mortgage Lending**

November 2009
Report No. 10-013



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Overall Conclusion

The Department of Savings and Mortgage Lending (Department) has participated in monitoring and oversight of financial institutions. However, the Department does not consistently (1) document its examination and monitoring activities or (2) comply with its policies and procedures. As a result, the Department cannot demonstrate that it consistently complied with all applicable statutes, administrative rules, and agency policy in monitoring the safety and soundness of institutions and overseeing the institutions identified as having a poor or deteriorating financial condition.

This audit report is the result of the continuation of a prior State Auditor's Office audit conducted at the Department from March 2009 to June 2009 (see *An Audit Report on the Department of Savings and Mortgage Lending*, State Auditor's Office Report No. 09-049, August 2009). The Department conducts the majority of its examinations jointly with the Federal Deposit Insurance Corporation (FDIC), and the August 2009 audit report included information regarding an audit scope limitation because the FDIC had not permitted the State Auditor's Office to access information necessary to address the objectives of the audit. After that audit report was published, the FDIC granted conditional access to certain records in August 2009 (see Appendix 2 for the FDIC's letter). This audit report covers only the audit work performed after the receipt of the conditional access to examinations of institutions.

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.

As of December 31, 2008, the Department regulated 28 institutions.

For its thrift examination and supervision strategy only:

- In fiscal year 2006, the Department reported having 8.8 average annual full-time equivalent (FTE) employees and received General Revenue appropriations of \$990,000.
- In fiscal year 2007, the Department reported having 12.0 average annual FTEs and received General Revenue appropriations of \$1.0 million.
- In fiscal year 2008, the Department reported having 13.8 average annual FTEs and received General Revenue appropriations of \$1.6 million.

Additional Oversight of State-chartered Savings Banks

In addition to oversight from the Department of Savings and Mortgage Lending, federally insured state-chartered savings banks are also under the oversight of the Federal Deposit Insurance Corporation (FDIC). The FDIC is an independent agency of the federal government that protects the funds depositors place in banks and savings associations. The FDIC directly examines and supervises savings banks for operational safety and soundness.

FDIC insurance covers all deposit accounts, including checking and savings accounts, money market deposit accounts, and certificates of deposit. The standard insurance amount currently is \$250,000 per depositor.

Source: *Deposit Insurance Guide*, FDIC.

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.

Key Points

The Department should maintain adequate documentation of its reviews of examination reports.

Auditors tested 43 examinations, 40 of which the Department conducted jointly with the FDIC. The Department consistently reviewed draft examination reports for the 24 full scope examinations tested. For those examinations, the examiner in charge submitted draft examination reports for the Department's final supervisory review and approval. Performing supervisory reviews helps the Department ensure that examination reports are supported and that its enforcement actions and ratings are consistent across institutions.

Full Scope Examinations

Full scope examinations are examinations required under Section 337.12 of the FDIC's rules. Under these rules, a full scope examination must take place at least once during each 12-month period. Annual examination intervals may be extended to 18 months under certain conditions.

The Department conducts full scope examinations jointly with the FDIC.

Texas Finance Code, Section 13.003, requires the Department's commissioner to appoint one or more deputy commissioners. However, the Department has not had a deputy commissioner since the current commissioner was appointed in March 2008. Having a deputy commissioner could help the Department ensure that it addresses the issues discussed below. For example, having a deputy commissioner could enable the Department to strengthen the supervision of its examinations of financial institutions.

The Department did not consistently review draft examination reports for conversion examinations or visitation examinations. Auditors identified the following issues:

- The Department could not provide documentation showing that it reviewed and approved 3 (50 percent) of the 6 visitation examinations for which the Department performed the lead role. It also could not provide documentation showing that it reviewed and approved 8 (80 percent) of the 10 visitation examinations for which the FDIC performed the lead role.
- The Department could not provide documentation showing that it reviewed and approved the three conversion examinations tested. In addition, conversion examination files did not contain documentation showing that these examinations were performed in accordance with all applicable rules. None of the three conversion examinations tested addressed whether the institution under examination met minimum capital requirements as required by Title 7, Texas Administrative Code, Section 75.90, and Texas Finance Code, Section 92.054.

Visitation Examinations

Visitation examinations are limited scope examinations that do not meet the minimum requirements of a full scope examination.

The Department conducts visitation examinations jointly with the FDIC.

Conversion Examinations

Conversion examinations are visitation examinations for existing institutions that are converting from another form of charter to a state savings bank.

The Department does not conduct conversion examinations jointly with the FDIC.

The Department should maintain adequate documentation showing that it complied with all applicable state laws, rules, and Department policies and procedures for examinations.

Documentation in the Department's examination files was incomplete. Having complete and adequate documentation is important because it supports the Department's overall conclusion regarding an institution's soundness and helps to ensure that the institution's ratings adequately depict its financial condition. Examples of incomplete documentation included the following:

- For 4 (15 percent) of 26 examination reports tested, (1) the Department was unable to show how it calculated certain financial figures or (2) working papers to which the examination report made reference were missing.
- Documentation showing that examiners performed additional examination procedures the Department had developed for specific institutions was not complete. Of the 43 examinations tested, the Department did not document whether it had developed specific instructions for 2 institutions under examination. The Department developed additional procedures for 28 of the examinations tested but, because documentation was not available, auditors were unable to determine whether the Department conducted the additional procedures for 13 (46 percent) of those 28 examinations.
- Thirty (70 percent) of the 43 examinations tested lacked documentation showing that the examiner in charge reviewed and approved examination working papers. The Department should ensure that it consistently reviews examination working papers. A lack of review increases the risk that working papers do not adequately document the results of work performed.

The Department should improve certain aspects of its ongoing analysis and monitoring of the institutions it regulates.

Auditors identified the following issues:

- The Department should ensure that it obtains and reviews institutions' annual independent audit reports and related documentation in a timely manner. Four of the institutions tested did not submit 5 (17 percent) of 29 independent audit reports to the Department by the required due date. Those 4 institutions submitted their independent audit reports an average of 15 days late. The Department could not provide evidence that it notified those institutions that they had not submitted their independent audit reports by the due date. It is important for the Department to review institutions' independent audit reports in a timely manner so that it can make timely decisions regarding any change in the soundness of institutions.
- The Department should ensure that it determines whether institutions have submitted all required information along with their independent audit reports. In 17 (74 percent) of 23 independent audit reports tested, the Department could not provide evidence that it verified whether the institutions had received a

report on internal control or a management letter from their independent auditors. It is important for the Department to review institutions' reports of internal control or management letters because these reports can contain information about reportable conditions that were not discussed in the independent auditors' opinions.

- The Department should ensure that institutions address their enforcement actions and respond to examination reports in a timely manner. For five institutions tested, three (60 percent) submitted at least one progress report that did not fully address their enforcement actions. The Department did not document whether it had followed up with these institutions.
- The Department should ensure that institutions respond to their examination reports. Institutions responded by the specified due date for 8 (80 percent) of 10 examination reports tested. However, the Department did not have documentation showing whether the remaining two institutions responded. Ensuring that all institutions respond to their examination reports would help the Department to ensure that the institutions acknowledge these reports and are aware of the reports' contents.

Auditors communicated other, less significant issues to the Department separately in writing.

Summary of Management's Response

The Department agrees with some of the recommendations and conclusions in this report and disagrees with others. Its responses and auditors' applicable follow-up comments are included in Chapter 3 on page 10.

Auditors' Follow-up Comment: The evidence we were able to collect supports our conclusions and related recommendations. The Department (1) did not maintain complete documentation of its efforts, (2) did not have written policies and procedures for many of its current practices, and (3) did not consistently follow the policies and procedures it has.

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 January 1, 2006, through March 31, 2009.

While the Department conducts the majority of its examinations jointly with the FDIC, the FDIC's activities were not included in the scope of this audit. As a result, this audit report provides no assurance regarding the effectiveness or appropriateness of the FDIC's activities. In a prior audit report, the State Auditor's Office reported on additional audit work related to the audit objectives (see *An Audit Report on the Department of Savings and Mortgage Lending*, State Auditor's Office Report No. 09-049, August 2009). That report should be considered in conjunction with this report.

This audit did not include any reviews of information technology.

The audit methodology included review of applicable laws, statutes, rules, regulations, and Department policies and procedures; review of the Department's documentation of institution examinations, examination reports, enforcement actions, progress reports, correspondence, independent audit reports, and incoming and outgoing mail logs; and interviews with Department employees and management.

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Detailed Results

Chapter 1

The Department Should Maintain Adequate Documentation of Its Examination Activities and Reviews of Examinations

The institutions that the Department of Savings and Mortgage Lending (Department) regulates are also subject to Federal Deposit Insurance Corporation (FDIC) regulations; therefore, the Department conducts the majority of its examinations jointly with the FDIC. This should not preclude the Department from complying with all applicable state rules, laws, and Department policies and procedures.

Examination Types

Full scope examinations: These are examinations required under Section 337.12 of the FDIC's rules. Under these rules, a full scope examination must take place at least once during each 12-month period. Annual examination intervals may be extended to 18 months under certain conditions.

Visitation examinations: These are limited scope examinations that do not meet the minimum requirements of a full scope examination and have a flexible format focused on specific examination objectives. A visitation examination can be used to examine a newly chartered or insured institution, an institution converting from another form of charter to a state savings bank, or an institution for which there has been a change in ownership control. Visitation examinations are also used to monitor institutions' compliance with corrective action programs or investigate adverse or unusual situations.

Conversion examinations: These are visitation examinations for existing institutions that are converting from another form of charter to a state savings bank.

Source: *Risk Management Manual of Examination Policies*, FDIC.

The Department conducts full scope examinations and visitation examinations jointly with the FDIC (see text box for information on the types of examinations). The Department conducts conversion examinations independently, and it assumes full responsibility for the results of those examinations. During all joint examinations, a qualified examiner from each entity serves as the examiner in charge for his or her respective entity. During joint examinations, one entity performs the lead role, and the examiner in charge from that entity is responsible for drafting the examination report. After both entities agree on the draft of an examination report, they both sign and approve the final examination report.

Auditors tested 43 examinations conducted between January 1, 2006, and March 31, 2009.¹ The Department conducted 40 of those examinations jointly with the FDIC (24 were full scope examinations and 16 were visitation examinations). The remaining three examinations tested were conversion examinations, which the Department performed independently.

For the 43 examinations that auditors tested, the Department provided sufficient evidence to support its participation in the examinations. However, auditors could not provide assurance regarding the effectiveness of the Department's efforts to monitor the safety and soundness of those institutions because the Department (1) did not maintain complete documentation of those efforts, (2) did not have written policies and procedures for many of its current practices, and (3) did not consistently follow the policies and procedures it has.

¹ Examinations that were in progress as of March 31, 2009, were excluded from testing.

The Department should maintain adequate documentation of its reviews of examination reports.

The Department's *Supervisory Manual* outlines the process for supervisory review and approval of examination reports associated with examinations that are led either by the Department or by the FDIC. The *Supervisory Manual* does not define the term "examination" and does not indicate that supervisory review and approval is specific to any one type of examination. In addition, the *Supervisory Manual* does not outline separate processes for each type of examination. Therefore, auditors applied the processes outlined in the *Supervisory Manual* to all examination types tested.

The Department consistently reviewed draft examination reports for the 24 full scope examinations tested. For those examinations, the Department's examiner in charge submitted draft examination reports for the Department's final supervisory review and approval. Performing supervisory reviews helps the Department ensure that examination reports are supported and that the Department's enforcement actions and institution ratings are consistent across institutions.

Texas Finance Code, Section 13.003, requires the Department's commissioner to appoint one or more deputy commissioners. However, the Department has not had a deputy commissioner since the current commissioner was appointed in March 2008. Having a deputy commissioner could help the Department ensure that it addresses the issues discussed below. For example, having a deputy commissioner could enable the Department to strengthen the supervision of its examinations of financial institutions.

Although the Department consistently reviewed draft examination reports for full scope examinations, it did not do so for conversion examinations or visitation examinations. Specifically:

- The Department could not provide documentation showing that it reviewed and approved 3 (50 percent) of the 6 visitation examinations tested for which the Department performed the lead role. It also could not provide documentation showing that it reviewed and approved 8 (80 percent) of the 10 visitation examinations tested for which the FDIC performed the lead role.
- The Department could not provide documentation showing that it reviewed and approved the three conversion examinations tested. In addition, conversion examination files did not contain documentation showing that these examinations determined compliance with all applicable rules. None of the three conversion examinations tested addressed whether the examiner ensured that the institution met a minimum initial capital requirement. The minimum initial capital requirement for savings banks has not been established as required by

Title 7, Texas Administrative Code, Section 75.90, and Texas Finance Code, Section 92.054.

The CAMELS Rating System

The Federal Financial Institutions Examination Council uses the Uniform Financial Institutions Rating System commonly referred to as the CAMELS rating system.

The CAMELS rating system is an internal rating system used to evaluate the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern. Each financial institution is assigned a composite and component rating based on a 1 to 5 numerical scale. A 1 indicates the strongest performance and management practices and the lowest degree of supervisory concern. A 5 indicates the weakest performance and management practices and the highest degree of supervisory concern.

The six components of the CAMELS rating system are:

- Capital Adequacy.
- Asset Quality.
- Management Practices.
- Earnings Performance.
- Liquidity Position.
- Sensitivity to Market Risk.

Source: *Federal Register*, Volume 61, No. 245.

The Department should maintain adequate documentation showing that it complied with all applicable state laws, rules, and Department policies and procedures for examinations.

In addition to the examination policies and procedures outlined in its *Supervisory Manual*, the Department has also adopted the FDIC's examination policies and procedures. At a minimum, full scope examinations are expected to address all six components of the CAMELS rating system (see text box) and should include all procedures necessary to complete the mandatory pages of the examination report.

The flexible format of visitation examinations does not require use of the standard examination report format; however, if the standard examination report format is not used, visitation examination reports should generally be conveyed in a memorandum.

Auditors reviewed the working paper files for the 43 examinations tested for evidence of compliance with all applicable state laws, rules, and Department policies and procedures. Relevant examiner comments in the available examination working papers for 32 (80 percent) of 40 joint examinations tested were noted in the final examination report in some form, but the working paper files themselves were generally incomplete. Having complete and adequate documentation is important because it supports the Department's overall conclusion regarding an institution's safety and soundness and helps to ensure that the institution's ratings adequately depict its financial condition. Examples of incomplete documentation included the following:

- The Department's documentation regarding the conclusions for institution ratings was incomplete. For 4 (15 percent) of 26 examination reports tested, (1) the Department was unable to show how it calculated financial figures contained in the examination report or (2) working papers to which the examination report made reference were missing from the Department's working paper files. Two of those four examinations were led by the Department, and the remaining two were led by the FDIC.
- The Department's documentation related to additional examination procedures was incomplete. The Department sometimes provides examiners with a

Examination Working Papers

Examination findings should be documented through a combination of brief summaries, bank source documents, report comments, and other examination working papers that address both management practices and condition.

Examination documentation should demonstrate a clear trail of decisions and supporting logic within a given area. Documentation should provide written support for the examination and verification procedures performed, the conclusions reached, the assertions of fact or opinion in the financial schedules, and the narrative comments in the examination report.

Source: *Risk Management Manual of Examination Policies*, FDIC.

supervisory package prior to each examination, in accordance with its *Supervisory Manual*, that includes background information on the institution and specific additional procedures for examiners to perform. (As discussed above, the *Supervisory Manual* does not define the term “examination” and does not indicate that preparation of a supervisory package is specific to any one type of examination. In addition, the *Supervisory Manual* does not outline separate processes for each type of examination. Therefore, auditors applied the processes outlined in the *Supervisory Manual* to all examination types tested.)

Developing and conducting additional examination procedures allows the Department to monitor conditions within the institution. The Department prepared supervisory packages for 28 of the 43 examinations tested. Twenty-seven (96 percent) of the 28 supervisory packages tested had supervisory approval as required by the Department’s *Supervisory Manual*, but the Department had no documentation showing that additional required procedures were performed during 13 (46 percent) of those 28 examinations.

- The Department’s working papers were not always adequately labeled. The FDIC’s *Risk Management Manual of Examination Policies*, which the Department had adopted, requires that all working papers be labeled with the institution’s name and location, dated, and signed or initialed by the examiner who prepared the working paper. The Department’s examiner bulletins regarding working paper documentation specify requirements in addition to the requirements in the FDIC’s manual, but they do not discuss the labeling of working papers and they do not specify any exception to following the requirements in the FDIC’s manual regarding labeling of working papers. However, 40 (93 percent) of 43 examination files tested contained at least one working paper that was not adequately labeled with the institution’s name and examination date. When those unlabeled working papers supported the institution’s CAMELS rating components, they could not be verified as belonging to that institution. In addition, one institution’s examination file contained a working paper labeled with another institution’s name.
- The Department’s working paper indices sometimes listed working papers that were missing. It should be noted that an index is not required, and not all working paper files included an index. Twenty-seven of the 43 examination files tested had an index, and for 6 (22 percent) of those 27, the index listed working papers that were missing. Examples of missing working papers included various modules documenting the work performed and conclusions related to the institution’s CAMELS rating components.

The Department should ensure that it consistently reviews examination working papers.

The Department's examiners in charge did not consistently document their reviews of examination working papers. The National State Auditors Association's *Best Practices in Carrying Out a State Regulatory Program* recommends supervisory review of the results of the examiner's work to ensure that it was conducted in a way that is consistent with applicable laws, regulations, and agency policies, and that any conclusions and recommendations are based on clear and sufficient evidence. The Department's lack of review increases the risk that working papers do not adequately document the results of work performed, and this issue could account for many of the documentation issues discussed above. Working paper files for 30 (70 percent) of the 43 examinations tested lacked documentation of the examiner in charge's review and approval.

In January 2009, the Department developed additional procedures that its examiners should follow. For 3 (75 percent) of the 4 examinations tested that were subject to those additional procedures, the examiner in charge did not complete the newly required "EIC Workpaper Review Form." For 1 (25 percent) of the 4 examinations tested, auditors were unable to determine whether field examiners had performed examination steps related to minimum liquidity requirements, and there was no documentation showing that the examiner in charge had ensured that the examination steps had been performed.

In addition, the Department did not consistently document its review of working papers prepared by examiners in training. Twenty-six (96 percent) of the 27 working papers prepared by examiners in training that auditors tested did not contain evidence of 2 levels of review. Therefore auditors were unable to determine whether the Department complied with its informal policy to perform two levels of review for those working papers.

Department policy also requires that, within two months of the issuance of an examination report, the chief examiner or a designee must perform an audit of examination working papers to ensure that the working papers comply with the Department's guidelines. However, the Department did not comply with that requirement for 38 (88 percent) of the 43 examinations tested. The Department had performed the required working paper audits only twice during the scope of the State Auditor's Office audit. If the Department had consistently complied with its policy in this area, the issues in documentation discussed above might have been identified and corrected.

The Department should protect its archived working papers from intentional or inadvertent modification.

The Department's archived working papers that maintain the history of the examiners' work and support examination conclusions were often unprotected

Microsoft Word and Excel documents that could be changed, either intentionally or inadvertently. Such modification could change the record of the examination's results. Ensuring that all archived working papers are adequately protected could help to protect the reliability of all historical information.

Recommendations

The Department should:

- Consistently review all examination reports in accordance with its *Supervisory Manual*. If that manual is not consistent with the Department's current practices, the Department should update it to reflect current policies, practices, and procedures.
- Document all policies, practices, and procedures for all types of examinations, such as full scope, visitation, and conversion examinations. The Department should ensure that any changes to policies and procedures provide assurance that (1) the Department has administrative oversight over its processes; (2) controls are sufficient to ensure that the Department has complied with all applicable statutes, administrative rules, and Department policy; and (3) policies and procedures align with regulatory best practices.
- Ensure that it sets, by rule, minimum initial capital requirements for savings banks.
- Maintain complete and adequate documentation to fully support the conclusions in examination reports, and write-protect archived working paper files to protect the reliability of the information that those working papers contain.
- Consistently follow all of its policies and procedures, including those that require examiners to address specific additional procedures, document how those procedures were carried out, and conduct and document all required reviews of working papers.
- Comply with Texas Finance Code, Section 13.003, and appoint one or more deputy commissioners.

The Department Should Improve Certain Aspects of Its Ongoing Analysis and Monitoring of the Institutions It Regulates

The Department should improve its ongoing analysis and monitoring of the institutions it regulates by:

- Obtaining and reviewing institutions' annual independent audit reports and related documentation in a timely manner
- Ensuring that institutions address their enforcement actions and respond to examination reports in a timely manner.

The Department should obtain and review institutions' independent audit reports and related documentation in a timely manner.

Federal and state regulations and state statute² require most institutions to engage an independent auditor to audit and report on the institutions' annual financial statements in accordance with generally accepted auditing standards. The institutions also must submit copies of their independent audit reports to the Department.

The Department's *Supervisory Manual* outlines the process by which the Department obtains and performs supervisory review and approval of institutions' independent audit reports. While the Texas Administrative Code requires institutions to submit their independent audit reports to the Department within 90 days after the end of their fiscal year, the Department's policy allows institutions to submit their independent audit reports within 120 days after the end of their fiscal year.

Auditors tested 29 independent audit reports that institutions submitted to the Department between January 1, 2006, and March 31, 2009, and determined that the Department generally complied with laws, regulations, policies, and procedures for obtaining and reviewing these reports. However, auditors identified the following issues:

- The Department did not consistently ensure that it received institutions' independent audit reports by the due date. Four of the institutions tested did not submit 5 (17 percent) of the 29 independent audit reports to the Department within 120 days after the end of their fiscal year. The Department could not provide evidence that it notified those four institutions that they had not submitted their independent audit reports by the due date. Those four institutions submitted their independent audit reports an average of 15 days late. It is important for the Department to obtain and review institutions' independent audit reports in a timely

² Title 12, Code of Federal Regulations, Chapter 363; Title 7, Texas Administrative Code, Sections 79.4 and 64.4; and Texas Finance Code, Section 96.051.

manner so that it can make prompt decisions regarding any change in the soundness of institutions.

- The Department did not consistently ensure that institutions submitted all required information along with their independent audit reports. For 23 of the independent audit reports tested, the Department should have determined whether the institutions had also received a report on internal control or a separate management letter from their independent auditors. However, in 17 (74 percent) of those 23 cases, the Department could not provide evidence that it verified whether the institution had received a report on internal control or a management letter from their independent auditors. Specifically:
 - For 10 of those institutions, the Department did not verify whether the institutions had received 13 management letters from their auditors.
 - For 2 of those institutions, the Department did not verify whether the institutions had received 3 reports on internal control from their auditors.
 - For 1 of those institutions, the Department did not verify whether the institution had received a management letter or a report on internal control from its auditor.

**Excerpts from the American
Institute of Certified Public
Accountants'
Standard for Independent Audit
Reports**

The fourth standard of reporting requires the auditor to express an opinion whether the financial statements taken as a whole are materially accurate. This opinion is included in the auditor's report.

The Report on Internal Control contains reportable conditions, if any, relating to internal control that may represent significant deficiencies or material weaknesses. Such reportable conditions are required by Statement on Auditing Standards 112 to be communicated in writing as a part of each audit.

The Management Letter identifies matters that were considered to be significant deficiencies or material weaknesses, as well as other matters the auditor felt needed to be communicated, such as other control deficiencies that are not significant deficiencies or material weaknesses.

While the Department reviewed all 29 independent audit reports tested, it did not determine whether the institutions received, and therefore should have submitted, the reports on internal control or the management letters discussed above.

The Department should ensure that institutions address their enforcement actions and respond to examination reports in a timely manner.

The Department generally imposes enforcement actions against institutions when a particular area or practice requires improvement. Enforcement actions can be informal or formal in nature. According to the National State Auditors Association's *Best Practices in Carrying Out a State Regulatory Program*, Department management should track and oversee the enforcement actions it imposes to ensure that institutions address all enforcement actions appropriately and in a timely manner. In 2008, the Department began maintaining a record of the enforcement actions it imposed.

Auditors tested five institutions on which the Department had imposed at least one enforcement action between January 1, 2006, and March 31, 2009, and determined that the Department did not consistently maintain documentation showing that it performed ongoing analysis of institutions' enforcement actions. Specifically, 3 (60 percent) of these 5 institutions submitted at least 1 quarterly progress report that did not fully address their enforcement actions.

While the Department may have discussed the issues surrounding the enforcement actions in its next examination report, the Department did not specifically address the progress reports that institutions submitted. The Department also did not document whether it followed up with these three institutions regarding their progress reports. Providing timely and accurate feedback to an institution could alert the institution that it has not addressed all enforcement actions and could help to ensure that the institution fully addresses its issues.

In addition, when the Department initially submits an examination report to an institution, the institution is generally required to respond by a specified due date. Institutions responded by the specified due date for 8 (80 percent) of 10 examination reports tested. However, the Department did not have documentation showing whether the remaining two institutions responded. Ensuring that all institutions respond to their examination reports would help the Department to ensure that the institutions acknowledge these examination reports and are aware of the examination reports' contents.

Recommendations

The Department should:

- Ensure that all institutions submit independent audit reports and related documentation by required due dates and in accordance with all applicable requirements.
- Communicate with institutions to ensure that the institutions meet all applicable requirements, and maintain documentation of all forms of this communication. If the Department relies on the work of another entity (such as the FDIC) in this effort, the Department should maintain documentation of the work of the other entity on which it has relied. Documentation should contain sufficient detail such as dates, parties involved, and outcomes.

The Department's Management's Response

Overall Conclusion

The department strongly disagrees with the auditors' overall tone and conclusions. The department has substantially complied with all applicable statutes and administrative rules in monitoring the safety and soundness of institutions it regulates and can demonstrate that it has properly conducted oversight of institutions having a poor or deteriorating financial condition.

The only inconsistency cited in statute relates to the appointment of a deputy commissioner, which was accomplished prior to the issuance of this report. The only inconsistency cited in rules was an incorrect determination by the SAO of capital verification where in truth the department performed the required functions and certified that each of the applicable institutions had between 200% and 900% more capital than required. Many of the inconsistencies in department policy or procedures repeatedly stem from the SAO's misinterpretation of the definition of what constitutes an examination.

In those instances in which the department agrees that it has not complied with its policies or procedures, the department either has or will revise its policy or procedure to reflect its practice. It should be understood, in each instance, there was no effect on the overall resulting examination findings or examination ratings concerning an institution. The department does not consider any of the auditors' findings to necessitate a change in the manner in which we monitor and regulate state savings banks.

The department has responded below with specific information regarding each detailed finding.

Auditors' Follow-up Comment: The evidence we were able to collect supports our conclusions and related recommendations. The Department (1) did not maintain complete documentation of its efforts, (2) did not have written policies and procedures for many of its current practices, and (3) did not consistently follow the policies and procedures it has.

Chapter 1

The Department should:

- ***Consistently review all examination reports in accordance with its Supervisory Manual. If that manual is not consistent with the Department's current practices, the Department should update it to reflect current policies, practices, and procedures.***

Management Response: The department takes exception to this finding and believes that it has consistently complied with the review of all examination reports in accordance with its Supervisory Manual and FDIC's examination manual for workpaper documentation. The core issue of findings throughout this audit stem from a misapplication by the SAO of the term "examination." While the Supervisory Manual does not define the term "examination," the FDIC's Examination Policies and Procedures, which have been fully adopted by the department for over 15 years, does define "visitations" and "limited scope examinations" as any examination that does not meet the minimum requirements of a full-scope examination and does not meet the requirements of Section 10(d) of the FDI Act. The FDIC Manual further states,

"Limited scope examinations and visitations have a flexible format and may be used to: determine changes in an institution's risk profile; monitor compliance with a corrective program; comply with SCOR follow-up requirements and to investigate adverse or unusual situations; determine progress in correcting deficiencies noted at the previous examination; act as an investigative and supervisory tool; and comply with schedules described under Other Situations below."¹

In addition, evidence of review of visitations by the department is documented through the issuance of a joint letter with the FDIC acknowledging the performance of a visit and summarizing the findings. Furthermore, evidence of review of a conversion exam is documented through the issuance of a Final Order granting or denying charter conversion.

¹*Risk Management Manual of Examination Policies, FDIC, Section 1.1, Basic Examination Concepts and Guidelines: Examination Types.*

Auditors' Follow-up Comment: We acknowledge in the report that the Department does not define the term "examination" and does not document the differences in the types of examinations it performs. The recommendation is that the Department document the policies, procedures, and practices it intends to follow for each type of examination it performs. The Department did not respond to this recommendation.

- ***Document all policies, practices, and procedures for all types of examinations, such as full scope, visitation, and conversion examinations. The Department should ensure that any changes to policies and procedures provide assurance that (1) the Department has administrative oversight over its processes; (2) controls are sufficient to ensure that the Department has complied with all applicable statutes, administrative rules, and Department policy; and (3) policies and procedures align with regulatory best practices.***

Management Response: The department will continue to utilize the flexible format allowed through FDIC policy for visitation and conversions. However,

in response to this finding, a standardized workpaper format will be established to allow for documentation consistency among these different types of on-site contacts. The extent of documentation maintained will be consistent with the purpose of the different types of on-site contact and reports.

- ***Ensure that it sets, by rule, minimum initial capital requirements for savings banks.***

Management Response: The department takes exception to this finding as minimum initial capital requirements for savings banks are established by Title 7, Texas Administrative Code, Section 75.90, and Texas Finance Code, Section 92.054. The Texas Finance Code, Section 92.054 requires minimum capital in an amount not less than the greater of the amount required by the FDIC for insurance or the amount required of a national bank. In the three instances cited in the audit, the amount required by the FDIC for insurance would be the greater. Each of these three institutions was already FDIC insured operating institutions pre-conversion. Upon conversion, each institution continued to be insured by the FDIC with no lapse in insurance coverage. The existence of FDIC insurance evidences for the department that sufficient capital exists for the institution to have obtained FDIC insurance, and, therefore, sufficient capital exists to comply with Texas Finance Code Section 92.054. Further, each of these pre-conversion visitations did document Tier 1 Capital ratios ranging from 10.72% to 45.43% or between 200% and 900% of the Prompt Corrective Action capital standards, as defined in Part 325 of the FDIC rules and regulations for a “Well Capitalized” financial institution, the standard followed by all state and federal regulatory agencies. This documentation was provided to the SAO and we see no merit to this finding.

Auditors’ Follow-up Comment: Title 7, Texas Administrative Code, Section 75.90, requires all institutions seeking conversion to meet the requirements of Texas Finance Code, Section 92.054. Texas Finance Code, Section 92.054, requires that minimum capital requirements for savings banks be set by rule. Minimum capital requirements are not set by rule for savings banks. The process of setting a rule allows the public access to the Department’s basis for setting minimum capital requirements.

- ***Maintain complete and adequate documentation to fully support the conclusions in examination reports, and write-protect archived working paper files to protect the reliability of the information that those working papers contain.***

Management Response: The department agrees with this finding; however, the exceptions regarding the department’s ability to document the

calculations of certain financial figures and working papers, referenced in the report, represent a minimal amount of the overall number calculations. In the two examinations in which the department was the lead, the examiner calculation references were maintained by the FDIC, as this work was prepared by FDIC examiners. However, the source documents provided by the institutions were maintained in the department's working paper files. Furthermore, the detailed analysis of these areas was thoroughly documented in the summary section of the report of examination. In the two remaining instances, in which FDIC acted as the lead, full documentation was maintained by the FDIC. While the department did not maintain all documentation, we do have access to any and all documents related to joint examinations. During the course of this audit, at SAO's request, the FDIC granted SAO access to the workpapers. However, no review of FDIC workpapers was performed. Nonetheless, all reports had been reviewed and verified by the department's EIC, as evidenced by the individual's signature on each report of examination. The department acknowledges that its intent is to properly indicate on the index those documents retained and to ensure their accuracy; however, the retention of these documents did not impact the overall conclusion regarding the institution's safety and soundness. While the exceptions noted were not material to the overall assessment, a quality control process will be fully implemented to review the completeness of the workpapers by December 31, 2009.

In regards to the archiving of the working paper files, the department agrees with this finding. Procedures to ensure the integrity of the files will be implemented by December 31, 2009.

- ***Consistently follow all of its policies and procedures, including those that require examiners to address specific additional procedures, document how those procedures were carried out, and conduct and document all required reviews of working papers.***

Management Response: The department takes exception to this finding. Documentation is maintained to support the review of additional procedures as designated by the Supervisory Analyst. The department does acknowledge that the review is not additionally documented directly on the Supervisory Package or that reference to the location in the workpapers is not made on the Supervisory Package. Doing so would be duplicative and unnecessary for our staff. We agree that someone unfamiliar with the process could conclude that the documentation is not obvious. Therefore, the process for Supervisory Packages will be eliminated by management as an unnecessary redundancy. Policies and procedures will be revised to reflect the deletion of this requirement by December 31, 2009.

The department agrees with the finding on a quality control review, i.e., internal audit of the workpapers. The department will establish procedures

for an internal audit review/quality control review of the working papers by December 31, 2009.

- **Comply with Texas Finance Code, Section 13.003, and appoint one or more deputy commissioners.**

Management Response: The intent of the Code has been complied with as the positions of General Counsel and Chief Examiner have assumed the responsibilities and authorities typically given to the position titled deputy commissioner. Furthermore, the department's general counsel has always been granted, through letter, the commissioner powers for situations of absence or inability to serve; however, we appointed a deputy commissioner prior to the issuance of this report.

Chapter 2

- **Ensure that all institutions submit independent audit reports and related documentation by required due dates and in accordance with all applicable requirements.**

Management Response: Although technically correct that four institutions submitted independent audit reports an average of 15 days late, the department's ongoing analysis and monitoring of these institutions were not effected. Verbal and email communication are initiated following the deadline and commitments received negate the need for a demand letter. The Independent Audits only serve as confirmation of results reported on quarterly. Furthermore, the Supervisory Analyst verbally confirmed whether or not a management and/or internal control letter was issued. While no written documentation from the institution was maintained by the department, confirmation is noted on the independent audit review form. In the future, the department will require the institution to submit in writing the lack of an internal control and/or a management letter.

- **Communicate with institutions to ensure that the institutions meet all applicable requirements, and maintain documentation of all forms of this communication. If the Department relies on the work of another entity (such as the FDIC) in this effort, the Department should maintain documentation of the work of the other entity on which it has relied. Documentation should contain sufficient detail such as dates, parties involved, and outcomes.**

Management Response: The department agrees with the finding. An impersonal letter of confirmation was not sent to the three institutions cited. Instead the department took the far superior action of sending examiners on site to confirm management statements and then meet face to face with the board of directors to deliver findings. This is all documented in the context of

the appropriate examination or visitation. In all three of the exceptions identified in which progress reports did not fully address their enforcement action, each was undergoing a visitation or examination at or close to the date the progress report was due. While there is no letter from the department and the FDIC responding to the progress on the enforcement action (these responses would be done jointly); detailed performance evaluation was documented in the visitation memorandum or examination report and discussed with management and the Board at the visitation or examination exit meetings. In any future similar situations we will continue to choose this superior action while modifying our documentation procedures to state it is a qualifying resolution.

In one of the two instances where a response to the report was not received within the specified time frame, the department disagrees with the finding. The examination response was received by the department in the required timeframe outlined in the transmittal letter. In the second exception, we acknowledge receipt was after the due date; however, a meeting was scheduled, prior to the deadline, with the department and the FDIC to discuss progress with the order. The department and FDIC agreed that the institution would be allowed to submit the progress report by hand delivery at the meeting. The coordination required in scheduling the various parties whose attendance was required at the meeting, resulted in a delay of 6 days. However, the department was engaged in ongoing communication with the institution and its condition.

The department will ensure that all of the above documentation is cross-referenced for inclusion in enforcement correspondence.

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 January 1, 2006, through March 31, 2009.

While the Department conducts the majority of its examinations jointly with the Federal Deposit Insurance Corporation (FDIC), the FDIC's activities were not included in the scope of this audit. As a result, the audit report provides no assurance regarding the effectiveness or appropriateness of the FDIC's activities.

In a prior audit report, the State Auditor's Office reported on additional audit work related to the audit objectives (see *An Audit Report on the Department of Savings and Mortgage Lending*, State Auditor's Office Report No. 09-049, August 2009). That report should be considered in conjunction with this report.

This audit did not include any reviews of information technology.

Methodology

The audit methodology included review of applicable laws, statutes, rules, regulations, and Department policies and procedures; review of the Department's documentation of institution examinations, examination reports, enforcement actions, progress reports, correspondence, independent audit reports, and incoming and outgoing mail logs; and interviews with Department employees and management.

Information collected included the following:

- FDIC rules and regulations.
- Title 12, Code of Federal Regulations, Chapter III.
- Texas Finance Code.
- Texas Administrative Code.
- *Best Practices in Carrying Out a State Regulatory Program*, National State Auditors Association, 2004.
- Department policies and procedures.

Information reviewed included the following

- Examination working paper files and Department indexes and checklists.
- Draft and final examination reports, transmittal letters, and the Department's examination review form.
- Enforcement actions, progress reports, and related correspondence.
- Institutions' independent audit reports and the Department's independent audit review form.

Procedures and tests conducted included the following:

- Testing of the Department's full scope, visitation, and conversion examinations to determine whether they were complete and conducted in accordance with applicable statutes, administrative rules, and Department policies.
- Testing of the Department's review of examination reports prior to release to determine whether these reviews were completed, conducted, and supervised in accordance with applicable Department policies.
- Testing of the Department's enforcement actions, progress reports, and correspondence to determine whether the Department (1) performed and documented related reviews in accordance with Department policies and (2) received progress reports in accordance with stipulated time frames reflected in the enforcement actions.
- Testing of the Department's reviews of institutions' independent audit reports to determine whether the Department (1) performed and documented these reviews in accordance with Department policies and (2) identified and addressed changes in institutions' financial condition.

Criteria used included the following:

- FDIC rules and regulations.
- Title 12, Code of Federal Regulations, Chapter III.
- Texas Finance Code.
- Title 7, Texas Administrative Code.
- *Best Practices in Carrying Out a State Regulatory Program*, National State Auditors Association, 2004.
- Department policies and procedures.

Project Information

Audit fieldwork was conducted from August 2009 through September 2009. With one exception, we conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Government Auditing Standards, Section 7.80(b), requires auditors to document the work performed to support significant judgments and conclusions, including descriptions of transactions and records examined. We did not comply with that standard, because we did not document the names of the financial institutions associated with the examination reports we tested. Due to the sensitive nature of the information, we did not document that information so that we could comply with the terms of a confidentiality agreement between the State Auditor's Office and the Department of Savings and Mortgage Lending. 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)
- J. Scott Killingsworth, CIA, CGAP, CGFM (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)

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

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



Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Division of Supervision and Consumer Protection

August 17, 2009

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

RE: Part 309 Request: Access to Exempt Information

Dear Mr. Keel:

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

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

The FDIC approves your office obtaining access to the confidential supervisory information maintained by the Departments that is jointly prepared or owned by the FDIC, for the time period and institutions specified in your request. The scope of such access shall be in accordance with existing information sharing practices between your office and the Departments for confidential information that is not shared jointly with the FDIC.

To the extent that FDIC served as lead/examining agency for any relevant reports of examination, your office should contact the FDIC Dallas Regional Office to gain access to the related work papers. We ask that such work papers not be removed from FDIC offices during your review, and that no copies be retained by your office. We also reserve the right to redact portions of any of these documents to remove material created by FDIC examiners or otherwise not bearing on your inquiry.

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


- (1) your office may not use the confidential supervisory information made available to it pursuant to this letter for any purpose other than in connection with its audit(s) of the Departments;
- (2) by granting access to you, the FDIC does not waive any claim of privilege or confidentiality with respect to the documents, as set forth in Part 309 of the Rules;
- (3) upon the completion of your review of the documents, your office will either promptly return to the applicable Department, or certify the destruction of, any copies; and
- (4) your office shall not disclose or further disseminate the exempt information for any purpose without the prior written approval of the FDIC's Dallas Regional Director, and your office shall comply with the prohibitions against disclosure contained in Part 309 of the Rules.

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

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

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

Sincerely,


Serena L. Owens
Associate Director

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

Related State Auditor's Office Work

Related SAO Work		
Number	Product Name	Release Date
09-049	An Audit Report on the Department of Savings and Mortgage Lending	August 2009

Copies of this report have been distributed to the following:

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

Office of the Governor

The Honorable Rick Perry, Governor

Members of the Finance Commission of Texas

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

Department of Savings and Mortgage Lending

Mr. Douglas B. Foster, Commissioner



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