

OFFICE OF FINANCIAL REGULATION
REGULATION OF FINANCIAL INSTITUTIONS

Operational Audit

March 2006 Through February 2008
and Selected Actions Through December 2008



COMMISSIONER OF THE OFFICE OF FINANCIAL REGULATION

The Office of Financial Regulation is administratively housed within the Department of Financial Services, but operates under the direction of the Financial Services Commission, which is comprised of the Governor, the Attorney General, the Chief Financial Officer, and the Commissioner of Agriculture. The Commission is responsible for appointing the Director of the Office of Financial Regulation, who may also be known as the Commissioner of Financial Regulation. Don Saxon served as Commissioner during the audit period.

The audit team leaders were Matthew Tracy, CPA, and Chris Stanisci, CPA, and the audit was supervised by Richard Munson, CPA. Please address inquiries regarding this report to Jane Flowers, CPA, Audit Manager, by e-mail at janeflowers@aud.state.fl.us or by telephone at (850) 487-9136.

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OFFICE OF FINANCIAL REGULATION

Regulation of Financial Institutions

SUMMARY

This operational audit of the Office of Financial Regulation (OFR) focused on OFR's regulation of State-chartered banks and credit unions. Our audit, covering the period March 2006 through February 2008, and selected actions taken through December 2008, also included a follow-up on prior audit findings contained in audit report No. 2007-090. Our audit disclosed the following:

Regulation of Banks and Credit Unions

REVIEW OF *DE NOVO* BANK APPLICATIONS

Finding No. 1: OFR did not adequately document, through the use of its established worksheets and checklists, the elements of *de novo* bank¹ applications that were reviewed for compliance with the requirements of Florida law and rules.

CREDIT UNION EXAMINATIONS

Finding No. 2: Contrary to OFR policies and procedures, OFR staff did not always adequately complete an examination checklist in support of the credit union examinations performed.

BANK EXAMINATION REPORTS

Finding No. 3: In conducting bank examinations, OFR was to follow the Federal Deposit Insurance Corporation (FDIC) *Risk Management Manual of Examination Policies (Policies)* and supplemented its guidance through memorandums to staff, notes from management meetings, and training schools provided through FDIC. Our audit found that OFR generally followed FDIC policies and procedures. However, we did find that OFR Reports of Examination did not always include all mandatory FDIC disclosures.

BANK EXAMINATION DOCUMENTATION

Finding No. 4: OFR had not established a single, uniform checklist to document the completion of all applicable bank examination procedures.

BANK AND CREDIT UNION EXAMINATION REVIEW

Finding No. 5: Area field offices did not always document the independent supervisory review of examination working papers and Reports of Examination.

FINANCIAL INSTITUTION SURVEILLANCE

Finding No. 6: OFR had not established written procedures related to on-going surveillance of State-chartered financial institutions.

Prior Audit Findings

OFR had taken adequate corrective actions for findings included in audit report No. 2007-090. Additionally, legislation designed to improve OFR's regulatory capabilities over the money services industry was adopted in June 2008.

¹ A *de novo* bank is a newly chartered bank, as opposed to a newly opened branch bank or a bank acquired through purchase.

BACKGROUND

Under Florida law², the Office of Financial Regulation (OFR) licenses and examines State-chartered financial institutions to provide for and promote the safe and sound conduct of business by those financial institutions. The Division of Financial Institutions (Division) carries out these statutory responsibilities.

As of September 30, 2008, OFR was responsible for regulating 213 commercial banks, 82 credit unions, 37 international bank offices, and 12 nondeposit trust companies with total assets exceeding \$105 billion. During the audit period, OFR completed 188 bank examinations, 117 credit union examinations, 41 international bank office examinations, and 20 trust company examinations.

The safety and soundness of financial institutions is evaluated under the Uniform Financial Institutions Rating System (UFIRS).³ Under UFIRS, a financial institution is assigned a composite rating based on an evaluation and rating of six components of the institution's financial condition and operations.⁴ This rating, commonly known as an institution's CAMELS⁵ rating, is scored on a 1 to 5 numerical scale, where 1 indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern. A 5 indicates the lowest rating, weakest performance, inadequate risk management practices, and the highest degree of supervisory concern. As a means to monitor the financial condition of certain State-chartered financial institutions requiring more than normal supervisory attention, OFR has implemented a monthly watch list. Institutions on the watch list include those with a CAMELS rating of 3, 4, or 5; institutions with a CAMELS management rating⁶ of 3 or higher; or any other institution where concern regarding safety and soundness is noted.

According to OFR, the percentage of State-chartered financial institutions⁷ on OFR's watch list increased from 13 percent in December 2007 to 24 percent in December 2008, as OFR reported weakening market conditions with a serious negative effect on State financial institutions' asset quality, liquidity, and earnings. OFR also indicated that more large and complex institutions were being added to the watch list, further increasing examination and supervisory review challenges. As of December 2008, the 24 percent of financial institutions on the watch list represented 33 percent of the total OFR-regulated assets. Additionally, as shown below in Table 1, OFR reported that the average number of hours required for bank and credit union safety and soundness examinations increased as the number of troubled institutions requiring additional hours of examination time by experienced examiners also increased. To address these increasing regulatory pressures, OFR has requested increases in the number of positions appropriated. In OFR's 2009-10 fiscal year Legislative Budget Request, an additional 20 positions were requested for the Division.

² Chapters 655 through 667, Florida Statutes.

³ UFIRS was adopted by the Federal Financial Institutions Examination Council and serves as a tool to evaluate the soundness of financial institutions on a uniform basis and to identify institutions requiring special attention or concern.

⁴ Credit unions are only evaluated on five components as they are not evaluated on sensitivity to market risk.

⁵ CAMELS – Capital Adequacy; Asset Quality; Management; Earnings; Liquidity; and Sensitivity to Market Risk.

⁶ The CAMELS management rating focuses on the capability of an institution's board of directors and management to identify, measure, monitor, and control the risks of an institution's activities and to ensure the institution's safe, sound, and efficient operation in compliance with applicable laws and regulations. The CAMELS management rating is also scored on a numerical scale of 1 to 5, where 1 is the highest rating and 5 is the lowest.

⁷ Financial institutions include commercial banks and savings associations, credit unions, international banks, and nondeposit trust companies.

Table 1
Division of Financial Institutions
Average State Safety and Soundness
Examination Hours

Institution	2005	2006	2007	2008
Bank	609	618	683	804
Credit Union	230	236	239	269

Source: OFR.

FINDINGS AND RECOMMENDATIONS

Finding No. 1: Review of *De Novo* Bank Applications

State law⁸ provides OFR the authority to permit a corporation to be formed under the laws of Florida for the purpose of becoming a State bank and conducting general banking business. State law⁹ also outlines the requirements for the written application requesting the authority to charter a *de novo* (new) bank.

OFR is responsible for reviewing applications and the information they contain in a documented, consistent, and thorough manner. In reviewing and approving the application of a *de novo* bank, OFR, among other things, must find that:

- Local conditions indicate a reasonable promise of successful operation for the proposed bank.
- The proposed capitalization is in such amount as OFR deems adequate and that the minimum capital requirements outlined by State law are met.¹⁰
- The proposed officers have sufficient financial institution experience, ability, standing, and reputation and the proposed directors have sufficient business experience, ability, standing, and reputation to indicate a reasonable promise of success.
- Provision has been made for suitable quarters at the location identified in the application.

Our audit disclosed that OFR staff had established various working papers for the *de novo* bank application review process. These working papers included several worksheets and checklists that could be used to document OFR’s review of the application and supporting documentation, as well as the applicant’s offering circular of securities.¹¹

While we noted evidence of OFR review during our evaluation of 15 *de novo* bank application files, we also found that in all applicable instances, OFR did not complete any of the established worksheets or checklists documenting the elements of the application and offering circular that were reviewed. In response to inquiry, OFR staff indicated that there was no policy or statutory requirement to complete these working papers for each application. However, there does exist an expectation that OFR be able to clearly demonstrate in its records that the applications have been reviewed, including the particular steps taken during the review and how those steps led the reviewer to conclude that the application did or did not meet the requirements of law. Moreover, the use of a systematic and documented approach, such as that represented by the worksheets and checklists, may better ensure new staff’s training and

⁸ Section 658.16, Florida Statutes.

⁹ Section 658.19, Florida Statutes.

¹⁰ During the audit period, Section 658.21(2), Florida Statutes, required that in no case may a bank’s total capital at opening be less than \$6 million (\$4 million for any bank opening in a nonmetropolitan statistical area) and at least 25 percent of the capital must be directly owned or controlled by the organizing directors of the bank.

¹¹ A bank’s initial offering circular includes, but is not limited to, information such as the par value of shares, the number of authorized shares, the price per share, and a description of certain shareholders’ rights.

understanding of the review process objectives and the nature, timing, and extent of the review procedures performed.

Recommendation: To promote the consistent review of *de novo* bank applications, as well as better ensure documentation and transfer of institutional knowledge, OFR should amend its current policies and procedures to require the completion of the established worksheets and checklists. To better facilitate the use of these documents, OFR should consider the development of a checklist encompassing into one standard document all of the review requirements pertinent to an application for a *de novo* bank.

Finding No. 2: Credit Union Examinations

Safeguarding of the public's private financial interests requires the regular and thorough conduct of examinations of financial institutions. These examinations are performed in a complex and challenging environment, necessitating that examiners maintain working papers that document findings and leave a trail of evidence for the work that is performed. OFR, in discharging its regulatory duties over State-chartered credit unions, has adopted the National Credit Union Administration's *Examiner's Guide* and has established a *State Credit Union Examination Manual (Manual)* to guide examiners through the credit union examination process.

To ensure consistent documentation and performance of appropriate examination procedures, the *Manual* requires that a standardized Examiner Guide and Checklist (checklist) be used for every examination. Additionally, the *Manual* notes that the checklist can also serve the purpose of a training checklist to follow the progress of individual new examiners.

Our audit disclosed that, contrary to OFR policies and procedures, in 3 of 15 credit union examinations reviewed (20 percent), OFR examiners did not adequately complete the checklist in support of the examination performed. Specifically, in one instance, the examiner did not prepare the checklist and in the other two instances, the checklists were not filled out completely. Consequently, for these examinations, there was less assurance that all appropriate procedures were performed during the examination. Additionally, the absence of a properly completed checklist diminishes the training value of the working papers to new examiners.

Recommendation: To better provide for the conduct and documentation of examination procedures, OFR should ensure that all credit union examinations are supported by completed checklists.

Finding No. 3: Bank Examination Reports

Examinations of financial institutions are critical to the maintenance of an effective regulatory environment in which institutions' adherence to laws and regulations is monitored and the financial integrity of institutions and the moneys they hold are protected. To provide for effective and efficient examinations, it is critical that written policies and procedures are established and adhered to in order to promote consistency and thoroughness in the examination and reporting process.

In conducting bank examinations, OFR was to follow the FDIC *Risk Management Manual of Examination Policies (Policies)* and supplemented its guidance through memorandums to staff, notes from management meetings, and training schools provided through FDIC. Our audit found that OFR generally followed FDIC policies and procedures. However, during the course of our audit, we noted in 9 of 15 bank examinations reviewed (60 percent), the Report of Examination did not contain all of the report pages listed as mandatory in Section 16.1 of the *Policies*. For 8 of these 9 examinations, the Report of Examination did not contain the *Comparative Statement of Financial Condition*, a mandatory

FDIC report page and, for 2 of the 9 examinations, the Report of Examination did not contain the FDIC-mandatory *Risk Management Assessment* report page. In these instances, neither the examination working papers nor any other documentation provided for our review explained the absence of these report pages.

In response to audit inquiry, OFR staff indicated that in all the cases cited above except one, the report pages were not required by FDIC as they involved institutions with 1 or 2 CAMELS ratings and fell under FDIC's MERIT¹² program for examinations. However, our review of the *Policies* did not clearly indicate that, for 1 or 2 CAMELS-rated institutions examined under the MERIT program, the Report of Examination elements listed as mandatory did not apply.

Absent consistent adherence to adopted FDIC examination standards, OFR increases the risk that examinations will not be performed and reported in a consistently effective and thorough manner.

Recommendation: We recommend OFR ensure that Reports of Examination contain all mandatory disclosures and that, where applicable, examination files contain explanations documenting the justification for any significant divergence from applicable reporting requirements.

Finding No. 4: Bank Examination Documentation

As highlighted in finding No. 2, OFR had established a standardized checklist that was required to be used during the examination of every credit union, recognizing that use of the checklist helped ensure that appropriate examination procedures were performed, working papers were adequately organized, and a good training resource was made available to new examiners. However, a single, standard checklist was not mandated by OFR for bank examinations. Our audit disclosed that, while working papers were maintained for the bank examination process, checklists demonstrating that all appropriate examination procedures had been performed were generally not completed. During our review of 15 bank examinations, we noted that for 10 of the 15 examinations (67 percent), OFR did not utilize an examination checklist of procedures performed. We did find that 5 of the examinations incorporated the use of an examination checklist. These checklists, though, were varied in form and were not always adequately completed.

Although we are cognizant that a checklist of examination procedures performed is not required by FDIC, and that the procedures performed during the examination process are sometimes unique to the nature and type of institution, OFR's bank examination process would benefit from the implementation of a uniform checklist that documents the examination procedures performed and that can serve as a guide and training tool for new examiners.

Recommendation: To better provide for the conduct and documentation of applicable examination procedures, OFR should establish a single, standard checklist of examination procedures. Such a checklist should, at a minimum, reference the procedures typically performed during an examination and make provisions for the identification of the examiner who performed the procedures, and when necessary, explanations as to the reason that a standard procedure was not performed.

Finding No. 5: Bank and Credit Union Examination Review

The examination function lies at the heart of OFR's ability to maintain the public's confidence in the integrity of State-chartered financial institutions. The end product of this function, a Report of Examination, is the culmination of examination procedures performed by staff located in area field offices throughout the State and represents the

¹² MERIT – Maximum Efficiency; Risk-Focused; Institution Targeted.

conveyance of all conclusions and recommendations to an institution's board of directors and management. The Reports of Examination for both banks and credit unions are prepared in OFR's area field offices, typically by the examiner-in-charge. Reports are then to be reviewed by the area financial manager, or designee. Following the completion of the area office review, the working papers are filed in the area office and the report is submitted to the Division's office in Tallahassee for final review.

Our audit found that for 2 of 15 bank examinations (13 percent) and 3 of 15 credit union examinations (20 percent) reviewed, evidence of independent supervisory review of the examination working papers and Report of Examination by the area field office was not evident. In response to our inquiry, OFR staff indicated that for the 2 bank examinations, the examiner-in-charge who wrote the report was also responsible for final review at the area office level because the supervisor was out of the office for an extended period of time. OFR further noted that for the 3 credit union examinations, no area office review was performed because the area financial manager was on extended leave.

While we noted that a final review of the Report of Examination was performed in the Tallahassee office for the examinations tested, absent an adequate review of the Report of Examination in conjunction with the supporting working papers, there is an increased risk that conclusions in the report may not be supported by the examination working papers.

Recommendation: To more adequately ensure the accuracy and completeness of all Reports of Examinations and supporting working papers, OFR should ensure reviews of Reports of Examination and the supporting working papers are completed by a staff person independent of the examination.

Finding No. 6: Financial Institution Surveillance

Off-site supervisory surveillance monitoring programs are designed to complement on-site examinations by allowing regulators to monitor the overall condition of banks between examinations. The information derived through the surveillance programs may indicate the need for a targeted visitation or an out-of-schedule special examination of a financial institution.

To evaluate the on-going financial condition of the financial institutions, OFR had access to FDIC, Federal Reserve Bank, and National Credit Union Association on-line databases that contained all of the respective organizations' off-site surveillance information. OFR had also developed its own off-site surveillance resources, including quarterly financial reports, a monthly problem loan watch list, and a monthly watch list of problem banks operating under formal and informal administrative action.

While OFR had off-site surveillance tools and resources available to facilitate the surveillance of the safety and soundness of each State-chartered financial institution, OFR had not developed written procedures governing the conduct and documentation of the surveillance procedures performed. The availability of written surveillance procedures would better ensure clear communication of management's expectations regarding the steps to be performed, when the work is to be performed, who is accountable for the completion and supervision of the work, how the performance of the work is to be documented, and to whom the results of the work are to be reported.

Recommendation: We recommend that OFR adopt written surveillance procedures.

PRIOR AUDIT FOLLOW-UP

As part of our audit, we determined that OFR staff had taken appropriate actions to correct the findings included in audit report No. 2007-090.

Additionally, subsequent to the March 2008 issuance of a Statewide grand jury report on the money services industry, the Legislature adopted into law¹³ measures designed to improve OFR's regulatory capabilities over the money services industry. These measures included:

- Requiring licensure rather than registration of money service businesses.
- Requiring OFR to periodically examine each licensee (at least every 5 years) and each new licensee within 6 months after license issuance.
- Requiring OFR to report certain violations to a criminal investigatory agency.
- Authorizing OFR to contract with third parties to conduct examinations.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Auditor General conducts operational audits of governmental entities to provide the Legislature, Florida's citizens, public entity management, and other stakeholders unbiased, timely, and relevant information for use in promoting government accountability and stewardship and improving government operations.

We conducted this operational 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.

This operational audit focused on OFR's activities to regulate State-chartered financial institutions and included a follow-up on prior audit findings disclosed in audit report No. 2007-090 related to the regulation of money transmitters and mortgage brokers and lenders. Our audit did not include a review of OFR's regulation of international bank or trust company activities, nor did it include a review of OFR's imposition of administrative actions against State-chartered financial institutions. The objectives of this audit were:

- To evaluate selected internal controls relevant to OFR's regulation of State-chartered financial institutions.
- To evaluate the extent to which OFR has complied with statutory provisions related to the regulation of State-chartered financial institutions.
- To determine whether OFR has corrected, or was in the process of correcting, deficiencies disclosed in audit report No. 2007-090.

Our audit included examinations of various records and transactions (as well as events and conditions) occurring during the period March 2006 through February 2008, and selected actions through December 2008. In conducting our audit, we:

- Interviewed OFR personnel and reviewed OFR procedures.
- Obtained an understanding of internal controls and tested key processes and procedures related to OFR's regulation of State-chartered financial institutions.

¹³ Chapter 2008-177, Laws of Florida.

- Tested 15 *de novo* bank applications from the population of 24 *de novo* bank applications to determine OFR’s compliance with significant governing laws and rules, as well as, to determine the adequacy of controls over the chartering of State financial institutions.
- Tested 15 bank examinations from the population of 188 bank examinations and 15 credit union examinations from the population of 117 credit union examinations to determine OFR’s compliance with significant governing laws and rules, as well as, to determine the adequacy of controls over the examination of State-chartered financial institutions.
- Tested 29 OFR Division of Financial Institution employee records from the population of 135 Division employees to assess the quality control process for ensuring staff were qualified and properly trained.
- Tested 10 complaints from the population of 40 complaints against State-chartered banks to determine whether complaints were timely and appropriately resolved.
- Performed various analytical reviews of OFR-provided data, including travel and wireless communication device expenditures.
- Evaluated OFR actions taken to correct the deficiencies disclosed in audit report No. 2007-090.
- Performed various other audit procedures as necessary to accomplish the objectives of the audit.

AUTHORITY

Section 11.45, Florida Statutes, requires that the Auditor General conduct an operational audit of each State agency on a biennial basis. Pursuant to the provisions of Section 11.45, Florida Statutes, I have directed that this report be prepared to present the results of our operational audit.



David W. Martin, CPA
Auditor General

MANAGEMENT’S RESPONSE

In a response letter dated January 30, 2009, the Acting Commissioner of the Office of Financial Regulation, concurred with our audit findings and recommendations. Management’s response is included as Exhibit A.

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**EXHIBIT A
MANAGEMENT'S RESPONSE**



OFFICE OF FINANCIAL REGULATION

ALEX HAGER
ACTING COMMISSIONER

**FINANCIAL SERVICES
COMMISSION**

CHARLIE CRIST
GOVERNOR

BILL MCCOLLUM
ATTORNEY GENERAL

ALEX SINK
CHIEF FINANCIAL OFFICER

CHARLES BRONSON
COMMISSIONER OF
AGRICULTURE

January 30, 2009

Mr. David W. Martin
Auditor General
State of Florida
G74 Claude Pepper Building
111 West Madison Street
Tallahassee, Florida 32399-1450

Re: Response to Preliminary and Tentative Audit Findings
Operational Audit of the Division of Financial Institutions
Audit Period 03/2006-02/2008

Dear Mr. Martin:

Enclosed is the Office of Financial Regulation's (Office) response to the Preliminary and Tentative Audit Findings for the operational audit of the Division of Financial Institutions.

This Office would like to thank the auditors of the Auditor General's Office for their diligence and thoroughness over the past twelve months in the conduct of this engagement. Your staff's professionalism and tireless efforts have produced an extensive review of the Division of Financial Institutions.

As brought out in part by the audit report, over the last four years this agency has had to expend more examination hours at each examination with an insufficient number of experienced examiners. As seen nation wide, Florida's financial institutions are experiencing the same adversities as other state-chartered financial institutions and some of our largest national banks.

It is apparent that the common issue identified in our audit is the need for adequate documentation and the use of checklists. The correction of these specific deficiencies will make this agency more efficient, and more importantly with the retirement of our experienced examiners, the revised/updated procedures and checklists will enhance our new examiners' understanding of the regulatory processes while serving as a work-guide and training tool.

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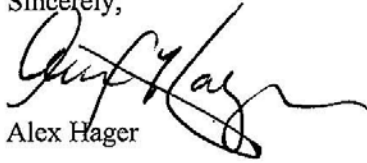
EXHIBIT A
MANAGEMENT'S RESPONSE (CONTINUED)

Mr. D. Martin
January 30, 2009
Page Two

I concur with the six findings and recommendations identified in the report and have directed my staff to implement actions to resolve and correct the deficiencies. Responses to the individual findings are contained in the attachment.

If you have any questions, please contact Inspector General Bob Dyar at 410-9712.

Sincerely,

A handwritten signature in black ink, appearing to read "Alex Hager", with a long, sweeping flourish extending to the right.

Alex Hager

Attachment

EXHIBIT A
MANAGEMENT'S RESPONSE (CONTINUED)

RESPONSE TO AUDITOR GENERAL FINDINGS

Finding No. 1: OFR did not adequately document, through the use of its established worksheets and checklists, the elements of de novo bank applications that were reviewed for compliance with the requirements of Florida law and rules.

OFR Response: Concur. We will adopt checklists and/or worksheets to document our existing de novo application review process. We will also update our policies and procedures to incorporate these checklists and/or worksheets and their use.

Finding No. 2: Contrary to OFR policies and procedures, OFR staff did not always adequately complete an examination checklist in support of the credit union examinations performed.

OFR Response: Concur. We have updated and formally adopted a checklist to document our current practices.

Finding No. 3: In conducting bank examinations, OFR was to follow the Federal Deposit Insurance Corporation (FDIC) *Risk Management Manual of Examination Policies* (Policies) and supplemented its guidance through memorandums to staff, notes from management meetings, and training schools provided through FDIC. Our audit found that OFR generally followed FDIC policies and procedures. However, we did find that OFR Reports of Examination did not always include all mandatory FDIC disclosures.

OFR Response: Concur. We will review and update our policies and procedures to address better documentation of the reasons for excluding certain examination pages in the final examination report as permitted under FDIC policies and procedures.

Finding No. 4: OFR had not established a single, uniform checklist to document the completion of all applicable bank examination procedures.

OFR Response: Concur. We will develop a checklist to document current practices and update our policies and procedures to incorporate the check list and its use.

Finding No. 5: Area field offices did not always document the independent supervisory review of examination working papers and Reports of Examination.

OFR Response: Concur. We will update our exam completion memo to better document the independent reviews of examination working papers and Reports of Examination. We will also review our policies and procedures to ensure that it addresses documentation and the requirement for independent review.

Finding No. 6: OFR had not established written procedures related to on-going surveillance of State-chartered financial institutions.

OFR Response: Concur. We are working on a policy to adopt current practices.

