

PERFORMANCE AUDIT
OF THE
FINANCIAL INSTITUTIONS BUREAU
DEPARTMENT OF CONSUMER AND INDUSTRY SERVICES

August 1999

EXECUTIVE DIGEST

FINANCIAL INSTITUTIONS BUREAU

INTRODUCTION

This report, issued in August 1999, contains the results of our performance audit* of the Financial Institutions Bureau (FIB), Department of Consumer and Industry Services (CIS).

AUDIT PURPOSE

This performance audit was conducted as part of the constitutional responsibility of the Office of the Auditor General. Performance audits are conducted on a priority basis related to the potential for improving effectiveness* and efficiency*.

BACKGROUND

FIB, within CIS, is governed by Sections 487.301 - 487.598 of the *Michigan Compiled Laws*. The overall administration of FIB activities is the responsibility of the commissioner of FIB, who is appointed by the Governor with the advice and consent of the Senate.

FIB's mission* is to maintain a regulatory climate conducive to healthy, competitive, and responsible financial institutions and, thereby, instill public confidence in these institutions. To fulfill its mission, FIB's four major objectives are to: ensure that financial institutions operate safely, soundly, and in compliance with applicable law; ensure that financial services are available to meet the needs of Michigan citizens; provide a full range of

* See glossary at end of report for definition.

competitive opportunities to financial institutions; and encourage financial institutions to advance economic development.

For fiscal year 1997-98, the Legislature appropriated approximately \$11.6 million for FIB operations, and FIB had 123 employees as of November 30, 1998.

AUDIT OBJECTIVES,
CONCLUSIONS, AND
NOTEWORTHY
ACCOMPLISHMENTS

Audit Objective: To assess FIB's effectiveness in regulating, supervising, and examining banks, credit unions, savings banks, and other licensed financial entities to ensure that those institutions operate safely and soundly.

Conclusion: We concluded that FIB was generally effective in regulating, supervising, and examining banks, credit unions, savings banks, and other licensed financial entities. However, we noted reportable conditions* relating to the examinations of credit union computer information systems and consumer finance examinations (Findings 1 and 2).

Noteworthy Accomplishments: FIB's Credit Union Division and Bank and Trust Division are accredited by national organizations. In 1989, the Credit Union Division was the first state credit union regulator to receive accreditation from the National Association of State Credit Union Supervisors (NASCUS). The Bank and Trust Division was among the first state banking departments to receive the Conference of State Bank Supervisors (CSBS) accreditation in 1986. The Credit Union Division was reaccredited by NASCUS in 1994, and the Bank and Trust Division was reaccredited by CSBS in 1993 and 1998. The

* See glossary at end of report for definition.

Divisions are subject to annual reviews to maintain their accreditations. For reaccreditation, NASCUS and CSBS review documentation and visit FIB to assess the Divisions' operations to determine that they continue to effectively fulfill their responsibilities.

Audit Objective: To assess FIB's processes and internal control structure* related to the billing and collection of supervisory, examination, application, license, and registration fees.

Conclusion: We concluded that FIB's processes and internal control structure related to the billing and collection of fees were generally effective. However, we noted a reportable condition related to the assessment of consumer finance late penalties (Finding 3).

Audit Objective: To assess FIB's compliance with applicable State statutes, the *Michigan Administrative Code*, State procedures, and CIS and FIB policies and procedures that could have a material impact on FIB operations.

Conclusion: We concluded that FIB was generally in compliance with applicable State statutes, the *Michigan Administrative Code*, State procedures, and CIS and FIB policies and procedures. However, as noted under the internal control objective, we noted a reportable condition related to the assessment of consumer finance late penalties (Finding 3).

Noteworthy Accomplishments: FIB established agreements with other state banking departments, the

* See glossary at end of report for definition

Federal Deposit Insurance Corporation, and federal reserve banks to coordinate the supervision of multi-state and State-chartered banks. FIB has also established agreements with the National Credit Union Administration and with other states through NASCUS for the supervision of multi-state and State chartered credit unions. These agreements improve FIB's ability to effectively and efficiently examine and supervise the institutions, and reduce the regulatory burdens on the institutions by minimizing duplication of efforts and ensuring consistency.

AUDIT SCOPE AND
METHODOLOGY

Our audit scope was to examine the program and other records of the Financial Institutions Bureau. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Our methodology included examination of FIB's records and activities for the period of October 1, 1996 through November 30, 1998. Our methodology included developing a preliminary review of FIB's operations. We analyzed the preliminary information and determined in which areas to concentrate our detailed analysis and testing. We designed tests to meet our audit objectives, evaluated the results of our testing, and reported our findings.

To assess FIB's effectiveness in meeting its responsibilities related to statutory examination requirements, we reviewed samples of examination files for documentation. This was to ensure that examinations were accurate and complete and that State financial institutions were operating safely and soundly.

We examined FIB's internal control structure related to the billing and collection of supervisory, examination, application, license, and registration fees. In addition, we reviewed a sample of billings to verify the propriety of amounts charged and collected. We also reviewed FIB's assessment of penalties for items not received on a timely basis.

**AGENCY RESPONSES
AND PRIOR AUDIT
FOLLOW-UP**

Our audit report contains 3 findings and 4 corresponding recommendations. FIB's preliminary response indicated that it will take steps to comply with all of the recommendations.

FIB complied with 5 of our 6 prior audit recommendations. The other recommendation was rewritten for inclusion in this report.

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Mr. Gary K. Mielock, Acting Commissioner
Financial Institutions Bureau
Town Center, Suite A
Lansing, Michigan
and
Ms. Kathleen M. Wilbur, Director
Department of Consumer and Industry Services
G. Mennen Williams Building
Lansing, Michigan

Dear Mr. Mielock and Ms. Wilbur:

This is our report on the performance audit of the Financial Institutions Bureau, Department of Consumer and Industry Services.

This report contains our executive digest; description of agency; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after the release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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Description of Agency

The Financial Institutions Bureau (FIB), within the Department of Consumer and Industry Services, is governed by Sections 487.301 - 487.598 of the *Michigan Compiled Laws*. The overall administration of FIB activities is the responsibility of the commissioner of FIB, who is appointed by the Governor with the advice and consent of the Senate.

FIB's mission is to maintain a regulatory climate conducive to healthy, competitive, and responsible financial institutions and, thereby, instill public confidence in these institutions. To fulfill its mission, FIB's four major objectives are to: ensure that financial institutions operate safely, soundly, and in compliance with applicable law; ensure that financial services are available to meet the needs of Michigan citizens; provide a full range of competitive opportunities to financial institutions; and encourage financial institutions to advance economic development.

FIB is the primary regulator responsible for the regulation, supervision, and examination of 132 State-chartered banks, 5 State-chartered savings banks, and 317 State-chartered credit unions. FIB's responsibilities are shared with three federal agencies (Federal Deposit Insurance Corporation, Federal Reserve System, and the National Credit Union Administration) which are also responsible for State-chartered federally insured depository institutions. FIB does not have regulatory responsibility for federally chartered financial institutions.

FIB is also responsible for licensing and regulating approximately 5,000 entities under various business and consumer finance acts. These acts include the Consumer Financial Services Act (Act 161, P.A. 1988); Credit Card Act (Act 379, P.A. 1984); Michigan BIDCO Act (Act 89, P.A. 1986); Mortgage Brokers, Lenders, and Servicers Licensing Act (Act 173, P.A. 1987); Motor Vehicle Sales Finance Act (Act 27, P.A. 1950, Extra Session); Regulatory Loan Act of 1963 (Act 21, P.A. 1939); Sale of Checks Act (Act 136, P.A. 1960); and Secondary Mortgage Loan Act (Act 125, P.A. 1981).

For fiscal year 1997-98, the Legislature appropriated approximately \$11.6 million for FIB operations, and FIB had 123 employees as of November 30, 1998.

Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our performance audit of the Financial Institutions Bureau (FIB), Department of Consumer and Industry Services (CIS), had the following objectives:

1. To assess FIB's effectiveness in regulating, supervising, and examining banks, credit unions, savings banks, and other licensed financial entities to ensure that those institutions operate safely and soundly.
2. To assess FIB's processes and internal control structure related to the billing and collection of supervisory, examination, application, license, and registration fees.
3. To assess FIB's compliance with applicable State statutes, the *Michigan Administrative Code*, State procedures, and CIS and FIB policies and procedures that could have a material impact on FIB operations.

Audit Scope

Our audit scope was to examine the program and other records of the Financial Institutions Bureau. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures were conducted during August through November 1998 and included examination of FIB's records and activities for the period October 1, 1996 through November 30, 1998.

To establish our audit methodology, we conducted a preliminary review of FIB's operations. This included discussions with agency staff regarding FIB functions, responsibilities, policies and procedures, licensing and examination rules, and the licensing and examination process. We then analyzed the preliminary information and determined in which areas to concentrate our detailed analysis and testing. We

designed tests to meet our audit objectives, evaluated the results of our testing, and reported our findings.

To assess FIB's effectiveness in meeting its responsibilities related to statutory examination requirements, we reviewed samples of examination files for documentation. This was to ensure that examinations were accurate and complete and that State financial institutions were operating safely and soundly.

We examined FIB's internal control structure related to the billing and collection of supervisory, examination, application, license, and registration fees. In addition, we reviewed a sample of billings to verify the propriety of amounts charged and collected. We also reviewed FIB's assessment of penalties for items not received on a timely basis.

Agency Responses and Prior Audit Follow-Up

Our audit contains 3 findings and 4 corresponding recommendations. FIB's preliminary response indicated that it will take steps to comply with all of the recommendations.

The agency preliminary response which follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require CIS to develop a formal response to our findings and recommendations within 60 days after release of the audit report.

FIB complied with 5 of our 6 prior audit recommendations. The other recommendation was rewritten for inclusion in this report.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS IN REGULATING, SUPERVISING, AND EXAMINING FINANCIAL INSTITUTIONS

COMMENT

Audit Objective: To assess the Financial Institutions Bureau's (FIB's) effectiveness in regulating, supervising, and examining banks, credit unions, savings banks, and other licensed financial entities to ensure that those institutions operate safely and soundly.

Conclusion: We concluded that FIB was generally effective in regulating, supervising, and examining banks, credit unions, savings banks, and other licensed financial entities. However, we noted reportable conditions relating to the examinations of credit union computer information systems and consumer finance examinations.

Noteworthy Accomplishments: FIB's Credit Union Division and Bank and Trust Division are accredited by national organizations. In 1989, the Credit Union Division was the first state credit union regulator to receive accreditation from the National Association of State Credit Union Supervisors (NASCUS). The Bank and Trust Division was among the first state banking departments to receive the Conference of State Bank Supervisors (CSBS) accreditation in 1986. The Credit Union Division was reaccredited by NASCUS in 1994, and the Bank and Trust Division was reaccredited by CSBS in 1993 and 1998. The Divisions are subject to annual reviews to maintain their accreditations. For reaccreditation, NASCUS and CSBS review documentation and visit FIB to assess the Divisions' operations to determine that they continue to effectively fulfill their responsibilities.

FINDING

1. Examinations of Credit Union Computer Information Systems

FIB did not conduct some examinations of computer information systems used by State-chartered credit unions on a timely basis. Also, FIB had not adopted a formal policy specifying the frequency for conducting examinations of computer information systems used by State-chartered credit unions.

The Federal Financial Institutions Examination Council Information Systems Examination Handbook, used by FIB as a guide for conducting computer information system examinations, recommends an examination of an institution's computer information system every 12 to 24 months, based upon the risk level associated with the financial institution. FIB's informal policy, based upon assessment of risk and resource allocation, was to only conduct computer information system examinations at State-chartered credit unions with at least \$5 million in assets and to rely upon computer information system examinations conducted by others.

A total of 310 State-chartered credit unions chartered by FIB, with total assets of \$10.8 billion, use computer information systems. Of those, 135 State-chartered credit unions operate their own in-house computer information systems, and 20 independent corporations provide computer information system services for 175 State-chartered credit unions. Our audit disclosed:

- a. FIB had not examined 34 State-chartered credit unions' in-house computer information systems. These State-chartered credit unions had total assets of \$78 million. Also, examinations of 57 State-chartered credit unions' in-house computer information systems were last performed by FIB more than two years ago. These credit unions had total assets of \$1.7 billion.
- b. FIB had not examined 3 independent corporations providing computer information system services to 5 State-chartered credit unions, that had \$159 million in total assets. FIB had not examined 11 such computer information system servicers for over 2 years. These servicers provided computer services to 101 State-chartered credit unions that had total assets of \$3.1 billion.

Examinations of computer information systems help to verify the accuracy and reliability of credit unions' records. The examinations also help identify risks that could threaten the safety and soundness of financial institutions. In addition, FIB's examiners use credit unions' computer-generated records to help assess the credit unions' financial condition and to help develop the scope of FIB examinations.

FIB acknowledged the importance of conducting computer information system examinations; however, FIB is currently concentrating its computer information system examination efforts on issues related to financial institutions' achieving year 2000 compliance.

RECOMMENDATIONS

We recommend that FIB conduct examinations of computer information systems used by State-chartered credit unions on a timely basis.

We also recommend that FIB adopt a formal policy specifying the frequency for conducting examinations of computer information systems used by State-chartered credit unions.

AGENCY PRELIMINARY RESPONSE

FIB agrees with both recommendations. FIB's Credit Union Division will conduct timely examinations, evaluations, or reviews of computer information systems used by State-chartered credit unions based upon an assessment of risk, appropriate resource allocations, and in accordance with a formal policy to be adopted. FIB's Credit Union Division will adopt a formal policy specifying the frequency for conducting examinations, evaluations, or reviews of computer information systems used by State-chartered credit unions by December 31, 1999.

FINDING

2. Consumer Finance Examinations

FIB had not developed formal criteria for selecting entities for examination to help ensure the most effective use of its resources and to minimize its risk exposure.

FIB is statutorily responsible for conducting examinations of entities licensed under the Regulatory Loan Act and the Consumer Financial Services Act. In addition, the *Michigan Compiled Laws* allow FIB to conduct examinations and investigations, as determined necessary, under the rules of the following consumer finance statutes: Credit Card Act; Mortgage Brokers, Lenders, and Servicers

Licensing Act; Motor Vehicle Sales Finance Act; Sale of Checks Act; and the Secondary Mortgage Loan Act. Our audit disclosed:

- a. FIB examined only 4 (13.8%) of the 29 licensees that required examination under the Regulatory Loan Act during our 25-month audit period. Section 493.10 of the *Michigan Compiled Laws* (a section of the Regulatory Loan Act) requires FIB to conduct an examination of each financial entity licensed under this Act at least once during every two-year period.
- b. FIB examined only 4 (3.7%) of 107 licensees in calendar year 1997 and 55 (30.4%) of 181 licensees through November of calendar year 1998 that required examinations under the Consumer Financial Services Act. Section 487.2062 of the *Michigan Compiled Laws* (a section of the Consumer Financial Services Act) states that FIB must conduct annual examinations of all financial entities licensed under this Act.
- c. FIB examined only 193 (4.3%) of the 4,464 entities licensed under the consumer finance statutes during calendar year 1996. In 1998, FIB examined only 82 (1.6%) of 5,052 consumer finance licensees.

FIB examinations of entities licensed under the consumer finance statutes help to ensure that licensees operate in a safe and sound manner and operate in compliance with the provisions of the consumer finance statutes. Because of the increasing number of licensees, FIB should develop formal criteria for selecting entities for examination.

RECOMMENDATION

We recommend that FIB develop formal criteria for selecting entities for examination to help ensure the most effective use of its resources and to minimize its risk exposure.

AGENCY PRELIMINARY RESPONSE

FIB agrees with the recommendation and will develop formal criteria for selecting entities for examination by December 31, 1999.

PROCESSES AND INTERNAL CONTROL STRUCTURE RELATED TO FEES

COMMENT

Audit Objective: To assess FIB's processes and internal control structure related to the billing and collection of supervisory, examination, application, license, and registration fees.

Conclusion: We concluded that FIB's processes and internal control structure related to the billing and collection of fees were generally effective. However, we noted a reportable condition related to the assessment of consumer finance late penalties.

FINDING

3. Assessment of Consumer Finance Late Penalties

FIB did not assess some consumer finance licensees late penalties for not submitting annual financial reports or license renewal fees on a timely basis.

Some consumer finance statutes allow FIB to assess late penalties to licensed entities that do not submit required financial reports or license renewal fees by specified dates. Licensees are subject to late penalties of \$25 per day with a maximum penalty of \$1,000. FIB's policy requires assessing licensees late penalties for submitting required documentation and fees more than seven days past their due dates.

Our review of approximately 1,700 licensees in calendar year 1997 and 1,800 licensees in calendar year 1998 disclosed 85 and 170 licensees, respectively, requiring late penalties for submitting documentation or fees that were more than seven days past due. However, FIB did not assess \$12,000 of late penalties to 15 licensees (17.6% of licenses requiring late penalties) in calendar year 1997 that did not submit required documentation or fees on a timely basis.

Consistently assessing late penalties helps to encourage timely submission of required financial reports and renewal fees.

RECOMMENDATION

We recommend that FIB assess consumer finance licensees late penalties for not submitting annual financial reports or license renewal fees on a timely basis.

AGENCY PRELIMINARY RESPONSE

FIB agrees with the recommendation and will assess licensees late penalties for not submitting required reports or license renewal fees on a timely basis unless the penalties are expressly waived by the FIB commissioner upon good cause being shown and documented.

COMPLIANCE WITH LAWS AND REGULATIONS

COMMENT

Audit Objective: To assess FIB's compliance with applicable State statutes, the *Michigan Administrative Code*, State procedures, and Department of Consumer and Industry Services (CIS) and FIB policies and procedures that could have a material impact on FIB operations.

Conclusion: We concluded that FIB was generally in compliance with applicable State statutes, the *Michigan Administrative Code*, State procedures, and CIS and FIB policies and procedures. However, as noted under the internal control objective, we noted a reportable condition related to the assessment of consumer finance late penalties (Finding 3).

Noteworthy Accomplishments: FIB established agreements with other state banking departments, the Federal Deposit Insurance Corporation, and federal reserve banks to coordinate the supervision of multi-state and State-chartered banks. FIB has also established agreements with the National Credit Union Administration and with other states through NASCUS for the supervision of multi-state and State chartered credit unions. These agreements improve FIB's ability to effectively and efficiently examine and supervise the institutions, and reduce the regulatory burdens on the institutions by minimizing duplication of efforts and ensuring consistency.

Glossary of Acronyms and Terms

CIS	Department of Consumer and Industry Services.
CSBS	Conference of State Bank Supervisors.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical for the amount of resources applied or minimizing the amount of resources required to attain a certain level of outputs or outcomes.
FIB	Financial Institutions Bureau.
internal control structure	The management control environment, management information system, and control policies and procedures established by management to provide reasonable assurance that goals are met; that resources are used in compliance with laws and regulations; and that valid and reliable performance related information is obtained and reported.
mission	The agency's main purpose or the reason the agency was established.
NASCUS	National Association of State Credit Union Supervisors.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.

reportable condition

A matter coming to the auditor's attention that, in his/her judgment, should be communicated because it represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.