STATE OF CONNECTICUT

AUDITORS' REPORT
DEPARTMENT OF BANKING
FOR THE FISCAL YEARS ENDED JUNE 30, 1999 AND 2000

AUDITORS OF PUBLIC ACCOUNTS
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May 8, 2002

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We have made an examination of the financial records of the Department of Banking for the fiscal years ended June 30, 1999 and 2000. This report consists of the Comments, Condition of Records, Recommendations and Certification that follow.

Financial statement presentation and auditing have been done on a Statewide Single Audit basis to include all State agencies. This audit has been limited to assessing the Department of Banking's compliance with certain provisions of financial related laws, regulations and contracts, and evaluating the Department of Banking's internal control structure policies and procedures established to ensure such compliance.

COMMENTS

FOREWORD:

The Department of Banking operates under the provisions of Title 36a, Chapters 664 through 669 and Title 36b, Chapters 672 to 672c. The Department functions as a regulatory agency responsible for the supervision, licensing and regulation of financial institutions and organizations within the State. Included among such institutions are State chartered banks and credit unions, small loan and second mortgage companies, sales finance companies, collection agencies, and security brokers, salesmen and investment counselors. Among the Department's other responsibilities are the administration and enforcement of Connecticut's Truth-in-Lending Law, other consumer credit laws and the Connecticut Uniform Securities Act.

John P. Burke served as Banking Commissioner during the audited period.

RÉSUMÉ OF OPERATIONS:

Banking Fund:

The Banking Fund (#1103) operated under Section 36a-65 of the General Statutes. All assessments and other fees received from entities subject to the supervision of the Banking Commissioner are placed in this special revenue fund. The expenditures of the Department of Banking are to be made pursuant to appropriation by the General Assembly and are charged to the Banking Fund.

Banking Fund receipts are summarized below, with amounts for the 1997–1998 fiscal year presented for comparative purposes.

	1997-1998	1998-1999	1999-2000
Receipt Type:			
Bank and credit union assessments	$ -	$1,146,859	$1,053,751
Registration of securities	4,976,446	4,150,876	4,731,349
Broker/dealer & investment advisor registration	6,966,380	7,343,000	8,273,460
Other application, license and examination fees	1,799,752	1,816,057	1,945,078
Penalties for failure to register	59,640	680,125	469,400
All other revenue	34,751	63,763	76,538
Total Banking Fund Receipts	**$13,836,969**	**$15,200,680**	**$16,549,576**

Subsection (a) of Section 36a-65 of the General Statutes gives the Commissioner discretion in the amount to assess banks and credit unions. As shown above, these assessments were resumed during the 1998-1999 fiscal year; these assessments had last been imposed during the 1995-1996 fiscal year. There was a significant increase in the number of registrations for broker/dealers and investment advisors, which resulted in the increased receipts. Registration of securities includes investment securities as well as certain business opportunities.

Banking Fund expenditures are summarized below, with amounts for the 1997-1998 fiscal year presented for comparative purposes:

	1997-1998	1998-1999	1999-2000
Expenditure Type:			
Personal services and fringe benefits	$8,657,499	$9,189,515	$ 10,704,374
Contractual services	2,777,951	2,246,658	1,626,536
Commodities	62,242	81,074	78,656
Revenue refunds	-	-	-
Sundry charges, excluding fringe benefits	440,000	487,230	(69,549)
Equipment	302,930	586,379	108,988
Total Banking Fund Expenditures	**$12,240,622**	**$12,590,856**	**$12,449,005**

Personal services and fringe benefits increased during the audited period. Filled positions increased slightly from 124 at June 30, 1998 to 130 as of June 30, 2000. In addition to the normal cost of living increases, there was an increase in the fringe benefit recovery rate from 35.55 percent for the 1998-1999 fiscal year to 41.28 percent for the 1999-2000 fiscal year. This rate is established annually by the State Comptroller. Also, the 1999-2000 fiscal year had 27 payrolls rather than the usual 26.

Our analysis of contractual services expenditures indicated major reductions in fees for outside professional services (02230) and outside consulting services (02370) in the 1999-2000 fiscal year; the Department's major computerization project, Business Integrated Public Service Support, was completed during the 1998-1999 fiscal year. The expenditure credit of $69,549 in sundry charges in the 1999-2000 fiscal year resulted from a determination by the State Comptroller that a refund of indirect cost recoveries was due to the Department. Within the equipment category, there was a significant decrease in EDP hardware purchases (09100) during the 1999-2000 fiscal year.

Increasing revenues accompanied by level expenditures has caused the fund balance of the Banking Fund (#1103) to increase as shown below:

Year Ended	Fund Balance
June 30, 1998	$12,456,911
June 30, 1999	15,014,675
June 30, 2000	19,056,747

PROGRAM EVALUATION:

Under the provisions of Section 2-90 of the General Statutes, the Auditors of Public Accounts are authorized to perform audits of programs and activities. We selected the Department's monitoring of derivative activity because there have been several recent spectacular financial failures caused by derivative financial investments. Out of concern expressed by the financial community, the Financial Accounting Standards Board issued Statement 133, *Accounting for Derivative Instruments and Hedging Activity* in 1998. For our program evaluation at the Department of Banking, we considered how the Department has integrated Statement 133 into its bank examination procedures. More specifically, we reviewed bank examination procedures and employee training materials relating to Statement 133.

A derivative is an investment vehicle or financial instrument whose value is derived from some other financial instrument, commodity, option, future, forward or swap. Additionally, derivatives include such esoteric financial instruments as collateralized mortgage obligations, interest-only strips, principal-only strips and even weather derivatives. Enron, which pioneered in the development of weather derivatives, has recently caused the largest bankruptcy ever. Derivatives have some similarities to insurance in that they can be used to mitigate the risk of market fluctuations in fair value, cash flow or foreign currency. Using the insurance analogy, financial risk can be shifted from the insured to the insurer. In a derivative transaction, one party is hedging a risk and the other party is absorbing the risk or speculating. Commercial banks are major participants in the derivatives market; at the end of the third quarter of 2001, the Comptroller of the Currency reported that American banks held $51.3 trillion notional amount of derivatives contracts. "Notional" refers to the face amount of a contract and does not necessarily correspond to the amount of cash that will be exchanged.

In December 1994, Orange County, California became insolvent because of its derivatives investments. The County's combined investment fund had enhanced its return by investing in repurchase agreements and inverse floaters; these had the effect of leveraging the investment return and later magnifying the losses. In September 1998, the hedge fund Long Term Capital Management (LTCM) in Greenwich, Connecticut, collapsed. LTCM had $1.4 trillion in notional value of derivatives contracts and was perhaps the world's single most active user of interest rate swaps.

Prior to the issuance of Statement 133, most derivative transactions were treated as "off-balance sheet", meaning that they were not accounted for in an entity's general ledger. Statement 133, which took effect January 1, 2001 for calendar year businesses, required that all derivative transactions be accounted for as either assets or liabilities on the balance sheet. Statement 133 requires that the hedging relationship between the derivative and the underlying transaction be "highly effective" in order to qualify for special accounting treatment, which matches gains or losses on the value of the derivative with gains or losses in the underlying transaction. "Highly effective" is defined as a correlation between 80 and 125 percent. For derivative instruments that fail the "highly effective" test, gains and losses that result from periodic mark-to-market requirements are immediately reflected in current earnings; "mark-to-market" is valuing financial instruments at current fair value rather than historical cost.

For businesses and banks in particular, derivatives entail certain financial risks as well as being used to hedge against other financial risks, such as market value, cash flow or foreign currency fluctuations. Some derivatives, such as options, function like highly leveraged investments; a price change in the underlying financial instrument is magnified in the derivative. There is also counterparty or credit risk; which occurs when the counterparty defaults on its obligation, such as in a bankruptcy. Derivatives also involve market risk. Markets can experience periods of reduced liquidity, which makes it difficult to close out a derivative position with an offsetting transaction. Certain derivatives are non-exchange traded, so these would have reduced marketability. Legal risk can occur when a defect in the contract impairs enforceability.

Because of the high level of risk inherent in derivatives transactions, strong internal controls are needed to ensure that transactions comply with a bank's investment policies and that errors are promptly detected and corrected. Strong controls will also ensure that all derivatives transactions are properly authorized, recorded and documented.

In the aftermath of the LTCM collapse, renewed emphasis has been placed on monitoring banks' risk management policies and procedures. The United States General Accounting Office, in its report on LTCM, "noted the unexpected interactions that could occur among market, credit and liquidity risk and emphasized the importance of stress testing to ensure that banks did not risk facing unacceptable exposures to their counterparties during such times." The Department uses bank examination programs prepared by the Federal Deposit Insurance Corporation (FDIC) and coordinates its examinations with those done by FDIC. In our review of these programs, we noted that financial instruments and derivatives are subjected to market risk "stress tests" and credit risk analysis.

As mentioned earlier, we also assessed the extent that Statement 133 had been integrated into the Department's bank examination process. We noted that a training program on Statement 133 had been provided to all examiners of the Bank Examination Division in February 2001; examiners were also given reference materials on Statement 133.

The Department of Banking supervises a total of 67 financial institutions in Connecticut, 32 savings banks, 18 bank and trust companies, five (5) limited purpose trust companies, five (5) foreign banks and seven (7) other financial entities. The Department has not had to issue any regulatory orders relating to derivatives activity during 2000 or 2001.

In conclusion, it appears that Department of Banking has adequately integrated Statement 133 into its bank examination procedures.

CONDITION OF RECORDS

Generally, the financial records of the Department of Banking were maintained in a satisfactory manner. However, we noted one (1) area where improvement is possible; this area is described in the following finding.

Reports not Submitted:

Criteria: Section 36a-14 of the General Statutes requires that annual reports on banking matters be submitted to the Governor and the Banking Committee of the General Assembly.

Condition: No such reports were submitted for the 1999 or 2000 year.

Effect: The Department of Banking has not complied with Section 36a-14 of the General Statutes.

Cause: Changes in the Department's computerized information system made it difficult to consolidate the necessary information.

Recommendation: The Department should comply with Section 36a-14 of the General Statutes and submit the required reports to the Governor and the Banking Committee of the General Assembly. (See Recommendation 1.)

Agency Response: "Although the reports you've cited are required by Section 36a-14 of the Connecticut General Statutes, it's important that I point out (1) the irrelevancy of two of the reports and (2) the changed manner in which two of the named reports are produced and made available to the governor and the public.

Published Annual Report on the Condition of all Entities Required to be Periodically Examined:
Changes in our computerized Management Information System did not allow us to create compatible statistical data tables as we had in the past. We are in the process of upgrading our MIS. In the interim, short confidential memoranda are provided to the Governor as a means of reporting the condition and activities of banks and other entities subject to my authority.

Administration of the Connecticut Truth-in-Lending Act Report:
This report was traditionally made a part of the published Annual Report of the Banking Commissioner which, as I mentioned above, is no longer being produced. Truth-in-Lending Reports for year-end 1998, 1999, and 2000 are available on the agency's web site.

Findings Concerning Home Financing Report:
Sections 36a-735 through 744 [of the General Statutes] speak to Connecticut financial institutions' Home Mortgage Disclosure Act responsibilities. The Department receives and reviews copies of confidential compliance examination reports from federal regulators and, as required in Section 36a-743, analyzes the practices and actions of financial institutions in the home financing area.

Administration of Interstate Banking Report:
Applications pertaining to the transactions identified in Public Act 90-2, An Act Concerning Nationwide Interstate Banking, must be filed with the Commissioner for his approval as required in Part 1 of Chapter 666 of Connecticut's banking law. Notices of these transactions are routinely published in the Department's *Weekly Bulletin*, copies of which are given to the Governor's Office.

The Department's web site also provides a compilation of mergers and acquisitions.

I hope my response addresses your concerns and demonstrates that although the format for my reporting to the Governor may be different, the goal for meeting the intended requirements of Section 36a-14 of the Connecticut General Statutes has been met."

Auditors' Concluding Comment: Since much of the information required in these reports is available at the Department's website, it should be possible to develop an email report containing links to that information.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

- We had recommended that the Department implement an automated time and attendance system. The Department implemented the State's BOSS (Business Office Support Services) in August 2000.

- An excess of $500 in the imprest petty cash fund should be returned to the Banking Fund. The $500 was returned during the 1999-2000 fiscal year.

Current Audit Recommendation:

The Department should comply with Section 36a-14 of the General Statutes and submit the required annual reports to the Governor and the Banking Committee of the General Assembly.

Comment:

The reports for 1999 and 2000 were never submitted.

INDEPENDENT AUDITORS' CERTIFICATION

As required by Section 2-90 of the General Statutes we have audited the books and accounts of the Department of Banking for the fiscal years ended June 30, 1999 and 2000. This audit was primarily limited to performing tests of the Agency's compliance with certain provisions of laws, regulations and contracts, and to understanding and evaluating the effectiveness of the Agency's internal control policies and procedures for ensuring that (1) the provisions of certain laws, regulations and contracts applicable to the Agency are complied with, (2) the financial transactions of the Agency are properly recorded, processed, summarized and reported on consistent with management's authorization, and (3) the assets of the Agency are safeguarded against loss or unauthorized use. The financial statement audits of the Department of Banking for the fiscal years ended June 30, 1999 and 2000, are included as part of our Statewide Single Audits of the State of Connecticut for those fiscal years.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial-related audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Department of Banking complied in all material or significant respects with the provisions of certain laws, regulations and contracts and to obtain a sufficient understanding of the internal control to plan the audit and determine the nature, timing and extent of tests to be performed during the conduct of the audit.

Compliance:

Compliance with the requirements of laws, regulations and contracts applicable to the Department of Banking is the responsibility of the Agency's management.

As part of obtaining reasonable assurance about whether the Agency complied with laws, regulations and contracts, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on the results of the Agency's financial operations for the fiscal years ended June 30, 1999 and 2000, we performed tests of its compliance with certain provisions of laws, regulations and contracts. However, providing an opinion on compliance with these provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. However, we noted certain immaterial or less than significant instances of noncompliance, which are described in the accompanying "Condition of Records" and "Recommendations" sections of this report.

Internal Control over Financial Operations, Safeguarding of Assets and Compliance:

The management of the Department of Banking is responsible for establishing and maintaining effective internal control over its financial operations, safeguarding of assets, and compliance with the requirements of laws, regulations and contracts applicable to the Agency. In planning and performing our audit, we considered the Agency's internal control over its financial operations, safeguarding of assets, and compliance with requirements that could have a material or significant effect on the Agency's financial operations in order to determine our auditing procedures for the purpose of evaluating the Department's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objectives.

Our consideration of the internal control over the Agency's financial operations and over compliance would not necessarily disclose all matters in the internal control that might be material or significant weaknesses. A material or significant weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with certain provisions of laws, regulations and contracts or failure to safeguard assets that would be material in relation to the Agency's financial operations or noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions to the Agency being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control that we consider to be material or significant weaknesses.

This report is intended for the information of the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited.

CONCLUSION

In conclusion, we wish to express our appreciation for the courtesies and cooperation extended to our representatives by the personnel of the Department of Banking during the course of our examination.

Harold L. Colvocoresses
Principal Auditor

Approved:

Robert G. Jaekle
Auditor of Public Accounts

Kevin P. Johnston
Auditor of Public Accounts

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