STATE OF CONNECTICUT

AUDITORS' REPORT
DEPARTMENT OF BANKING
FOR THE FISCAL YEARS ENDED JUNE 30, 2008 and 2009

AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ❖ ROBERT G. JAEKLE

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July 23, 2010

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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, 2008 and 2009. This report consists of the Comments, Condition of Records, Recommendations and Certification that follow.

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 internal control policies and procedures established to ensure such compliance. Financial statement presentation and auditing have been done on a Statewide Single Audit basis to include all State agencies, including the Department of Banking.

COMMENTS

FOREWORD:

The Department of Banking (Department or Agency) operates under the provisions of Title 36a, Chapters 664 through 669 and Title 36b, Chapters 672 to 672c of the Connecticut General Statutes. 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 State chartered credit unions, suppliers of consumer credit such as mortgage lenders, brokers, consumer collection agencies, small loan companies, check cashers, and landlord/tenant conflicts. The Department receives the majority of its revenues through the registration, supervision, and examination of the securities business within the State, including brokerage firms, investment banking houses, retail stockbrokers and investment advisors. The Department administers and enforces Connecticut's Truth-in-Lending Law and Connecticut's Uniform Securities Act, among other consumer-credit laws.

Howard F. Pitkin was appointed Banking Commissioner on October 1, 2006, and served throughout the audited period.

New Legislation:

Public Act 07-156, effective September 30, 2008, allowed the Banking Commissioner to participate in the National Mortgage Licensing System. This Act required mortgage originators to be licensed rather than registered, allowed the system to process licenses as well as to receive and maintain related records. Certain reports concerning the system were required to be submitted by the Banking Commissioner to the General Assembly's Committee on Banks. The initial report was sent on October 26, 2009. Public Act 08-176 later amended Public Act 07-156, in part, by changing the name of the system to the Nationwide Mortgage Licensing System, and moving up the effective date of the provisions affecting the system from September 30, 2008 to July 1, 2008.

Public Act 08-176, Sections 12, 14, 20 and 80, effective July 1, 2008, with certain provisions effective upon passage, or June 12, 2008, appropriated $21,000,000 of Banking Fund amounts to the following:

- Connecticut Housing and Financing Authority (CHFA) in the amount of $14,000,000 for a program to turn foreclosed properties into affordable housing and to establish a mortgage crisis job training program
- Labor Department in the amount of $2,500,000 for a mortgage crisis job training program
- Judicial Department in the amount of $2,000,000 for a foreclosure mediation program
- State Treasury in the amount of $2,500,000 for assistance with bond-related expenses

Of the total appropriations of $21,000,000, $13,826,350 was expended, and $7,173,650 lapsed as of June 30, 2009, and remained in the Banking Fund. The funds that lapsed included $4,000,000 for the CHFA and $2,500,000 for the State Treasury.

Public Act 08-176, Section 77, effective June 12, 2008, also established the Commission on Nontraditional Loans and Home Equity Lines of Credit (Commission) and the Banking Commissioner served as its Chairperson. The Commission was asked to determine the number of homeowners who were affected by nontraditional loans and home equity lines of credit and other information. The Commission met but was unable to progress as funding was not appropriated and, therefore, not available to acquire rights to a database at a cost of $100,000. The Commissioner reported to the General Assembly's Committee on Banks on November 6, 2008, that without the funding, information related to the Commission's charge could not be developed.

Public Act 09-1, Section 17, effective from passage on January 15, 2009, authorized the transfer of $15,000,000 from the Banking Fund to the General Fund to address deficit mitigation concerns for the fiscal year ending June 30, 2009.

Public Act 09-111, Section 2, and 42, effective from passage on May 26, 2009, authorized the transfers of $6,000,000 from the Banking Fund and $245,000 from the Investor Education Fund, respectively, to the General Fund to address deficit mitigation concerns for the fiscal year ending June 30, 2009.

Task Force:

The Sub-Prime Mortgage Task Force (Task Force) was convened by Governor M. Jodi Rell on April 10, 2007. This Task Force was comprised of banking and mortgage experts to examine and make recommendations regarding the issue of sub-prime lending in Connecticut. Commissioner Pitkin served on the Committee as co-chairperson along with the Executive Director of the Connecticut Housing Financing Authority. The final report was issued on November 9, 2007. The major recommendations in the report were to implement an awareness campaign, to add capacity to the State's housing counseling infrastructure, to sponsor a mortgage refinance program for those affected by sub-prime mortgages, and to initiate regulatory, policy and consumer education and protection measures to prevent a recurrence of the problems resulting from sub-prime lending practices.

RÉSUMÉ OF OPERATIONS:

Receipts:

Receipts of the Department of Banking are summarized below by fund for the fiscal years ended June 30, 2007, 2008 and 2009:

	2006-2007	2007-2008	2008-2009
Banking Fund	$29,103,183	$20,300,604	$20,493,591
Grant/Restricted Fund	285,043	11,825	-0-
Total Receipts by Fund	**$29,388,226**	**$20,312,429**	**$20,493,591**

Receipts of the Department of Banking are summarized below by revenue category for the fiscal years ended June 30, 2007, 2008 and 2009:

	2006-2007	2007-2008	2008-2009
Fees	$17,040,899	$17,537,868	$17,732,950
Licenses	7,892,203	2,155,260	2,370,960
Fines	4,136,915	595,050	319,333
Miscellaneous	318,209	24,251	70,348
Total Receipts by Category	**$29,388,226**	**$20,312,429**	**$20,493,591**

Total receipts decreased by 31 percent and increased by 1 percent during the fiscal years ended June 30, 2008 and 2009, respectively. Over 75 percent of the receipts were collected by the Securities and Business Investment Division, which collects registration fees from investment advisors and brokers, and for registration of securities. The remaining revenues were collected by the Financial Institutions Division and the Consumer Credit Division in nearly equal percentages. Revenues for licenses decreased because certain mortgage-related licenses that were formerly paid on a two-year cycle are now paid annually and because there was a precipitous decline in the number of requests for mortgage-related licenses. Revenues for fines also decreased because large fines were assessed and collected during the fiscal year ended June 30, 2007, and subsequent fines were not as large.

Expenditures:

The expenses of the Department of Banking are made pursuant to appropriations by the General Assembly. Expenditures for the fiscal years ended June 30, 2007, 2008 and 2009, totaled $16,472,325, $17,504,576 and $18,209,701, respectively. Most expenses were charged to the Banking Fund. Those expenditures charged to the Grant/Restricted Fund were for investor education programs. A summary of expenditures by fund is presented below:

	2006-2007	**2007-2008**	**2008-2009**
Banking Fund	$16,454,815	$17,481,962	$18,184,494
Grant/Restricted Fund	17,510	22,614	25,207
Total Expenditures	**$16,472,325**	**$17,504,576**	**$18,209,701**

A summary of expenditures for the Department of Banking by account code is presented below:

	2006-2007	**2007-2008**	**2008-2009**
Personal Services & Employee Benefits	$14,367,251	$15,164,544	$15,591,808
Employee Expenses, Allowances & Fees	509,897	434,049	431,883
Purchases & Contracted Services	411,798	424,872	405,932
Motor Vehicle Costs	10,642	11,555	10,909
Premises & Property Expenses	721,116	721,082	722,093
Information Technology	191,658	403,562	279,647
Purchased Commodities	55,759	55,170	35,459
Other Charges	199,519	179,237	731,970
Capital Outlays – Equipment	4,685	110,505	-0-
Total Expenditures	**$16,472,325**	**$17,504,576**	**$18,209,701**

Expenditures increased 6.3 percent and 4.0 percent during the fiscal years ended June 30, 2008 and 2009, respectively. Personal services and employee benefits increased 5.5 percent and 2.8 percent during the fiscal years ended June 30, 2008 and 2009, respectively. The increases were due to merit raises, cost-of-living adjustments, medical insurance costs, and changes in the fringe benefit contributions to the State Employees' Retirement System as established by the State Comptroller. Personal services and fringe benefits comprised over 86 percent of the Department's total expenditures. Filled positions totaled 119 as of June 30, 2009. Information technology costs increased 111 percent and then decreased 31 percent due to consulting services, and computer hardware and software purchases for the Consumer Credit Division. The increase in other charges was due to the State Comptroller's methodology change in the Statewide Cost Allocation Program.

Fund Balance:

The budgetary fund balance plus reserve amounts for the fiscal years ended June 30, 2007, 2008 and 2009 was $50,992,608, $53,811,250 and $21,293,993, respectively. The decrease in the fiscal year ended June 30, 2009, was due to the transfers of funds authorized under Public Act (P.A.) 08-176, P.A. 09-1 and P.A. 09-111, which were discussed under New Legislation.

CONDITION OF RECORDS

Our audit of the Department of Banking found areas where improvement is needed, as described in the following findings:

Sick Leave and Compensatory Time:

Criteria: Section 5-247-3 of the Regulations of State Agencies (Regulations) states that employees may be granted paid sick leave if they are incapacitated for duty. Section 5-247-11 of the Regulations requires medical certificates be submitted for any duration of sick leave, if absence from duty recurs frequently or habitually. Article 19, Section 10, subsection (3), of the Administrative and Residual Contract, expiring June 30, 2011, states that a medical certificate may be required of an employee, provided the employee has been notified that a certificate will be required.

The Management Personnel Policy 06-02, Compensatory Time for Employees Exempt from Collective Bargaining, as issued by the Department of Administrative Services, indicates that compensatory time for managers shall not accumulate for travel or commuting purposes.

Condition: We found one employee of 20 we tested whose pattern of usage suggested excessive absenteeism. Although the Department noticed the pattern, it did not inform the employee that a medical certificate would be required. Between January 2007 and February 2010, the employee used 272 hours of sick time, 200 of which occurred before and after weekends, holidays and vacations. Although excessive use of sick time does not necessarily indicate abuse, management should take appropriate action to ensure any potential abuse is detected.

We also found that compensatory time was earned by two managers for travel purposes. While both managers' travel was for essentially the same trip, one manager received 34 hours of compensatory time, while the other received 14 ½ hours.

Effect: Time off with pay was granted by the Department to those who may or may not be eligible for certain benefits.

Cause: Management did not follow through on its concerns over the pattern of sick time usage and did not clearly document the reason for certain hours of compensatory time granted to managers.

Recommendation: The Department of Banking's Financial Institutions Division should adequately follow through on its concerns and document the information necessary to support the sick and compensatory time it grants to employees. (See Recommendation 1.)

Agency Response: "The Department of Banking Human Resources Department will continue to monitor employees' attendance records on a quarterly basis and report to the appropriate manager/Division Director any concerns/issues with the attendance. Additionally, the DOB Attendance Policy will be reissued on an Agency-wide basis annually as a reminder of the agency policy and procedures."

Monitoring Compliance with Restriction Provisions:

Criteria: Sections 36a-11 and 36a-12 of the General Statutes impose certain restrictions on employees of the Department of Banking (Department) with respect to relationships and transactions with regulated individuals and entities. Proper internal controls would ensure that monitoring compliance with these provisions is performed on a continuous basis.

Condition: The Department does not have procedures in place to monitor, on a continuous basis, compliance with those provisions that impose certain restrictions on employees' relationships and transactions with regulated individuals and entities. The Department does inform new employees of the need to adhere to the restriction provisions.

Effect: The Department may not be aware of certain relationships and transactions that employees have with regulated individuals and entities.

Cause: The existing policy did not provide for monitoring compliance.

Recommendation: The Department of Banking should have procedures in place to monitor compliance with Sections 36a-11 and 36a-12 of the General Statutes. (See Recommendation 2.)

Agency Response: "The Department of Banking's Human Resources Department will redistribute on an annual basis the Memorandum on Restrictions on Department of Banking Employee Relationships and Investments with Regulated Entities along with a copy of the C.G.S. Sec. 36a-11 and Sec. 36a-12. Employees will sign off that they have received the policy and understand it is their responsibility to read and comply with the policy."

Computer Hardware and Software Purchasing:

Criteria: The State Comptroller's Property Control Manual states that agencies are responsible for maintaining a system to help ensure that the State's assets are acquired and managed to avoid excess and dormant inventory.

Section 4d-7, subsection (d), of the General Statutes requires an approved business plan be in place prior to the implementation of a proposal for information system software. Section 4a-58, subsection (b), of the General Statutes requires that sole source purchases in excess of $50,000 be approved by the Standardization Committee.

Condition: The Department of Banking purchased computer hardware during May of 2008 that was not used as of February 1, 2010. There were 37 desktop computers, 28 laptop computers, 38 docking stations, and 80 replacement batteries, many of which were in their original boxes. The purchases totaled an estimated $75,572. Also, the Department purchased a software license in the amount of $150,000 that was unused as of February 1, 2010. Terms of the payment agreement obligated future budget periods without explanation. The most recent payment in the amount of $35,000 was made on September 1, 2009, nine months after the project was put on hold. Certain information that appears to be required by the General Statutes, including Standardization Committee approval and an approved business plan, was not available to document the purchase requirements.

Effect: Computer purchases that remain unused for significant periods of time are a waste of resources that could have been better used for more immediate needs.

Cause: Hardware purchases were made that exceeded the Department’s needs. For the software license purchase, the Department of Information Technology (which assisted in the purchase of the software on behalf of the Department of Banking) did not appear to require Standardization Committee approval or an approved business plan in accordance with the General Statutes.

Recommendation: The Department of Banking should more carefully assess its needs before making computer-related purchases and should determine how best to document the approval requirements for future software license purchases. (See Recommendation 3.)

Agency Response: “The Department of Banking made its hardware purchases based on the anticipated needs of the agency and projected future needs. Due to early retirements and funding issues for necessary IT projects, the agency had excess hardware that could not be deployed in a timely fashion. The Department will monitor closely its future needs for both hardware and software initiatives to ensure compliance with the General Statutes as well as maintaining complete documentation of the approval requirements for our software initiatives.”

Monitoring of Services:

Criteria: Sound business practices and Statement on Auditing Standard No. 70 (SAS 70) require that when an outside service organization performs such services as the processing, executing and recording of transactions, an outside audit report on the processing of those transactions should be obtained.

Condition: The Consumer Credit Division within the Department of Banking contracts with the National Mortgage Licensing System to collect and forward certain revenues to the State of Connecticut. Other states also contract with the same vendor. A SAS 70 report, which would highlight any areas of concern about the processing of revenues, was not available as of April 5, 2010.

Effect: The Consumer Credit Division is unable to monitor and assess its contractor appropriately for any areas needing improvement.

Cause: The contract terms for this new system of collections did not require a SAS 70 report and management may not have realized its importance.

Recommendation: The Department of Banking's Consumer Credit Division should seek to obtain and review the audit report on the processes of the outside service organization that it hired to perform revenue collection services. (See Recommendation 4.)

Agency Response: "The Department of Banking's Consumer Credit Division will continue to work with the Conference of State Bank Supervisors (CSBS) to close the gap that exists without a SAS 70 report in NMLS. There have been conversations with the CSBS Audit Committee and currently audit standards are being worked on which would be increased as required by Federal law. There is no dispute that additional reporting information is necessary from an auditing perspective. The Department is committed to working with CSBS in ensuring that these audit standards are implemented."

Cost Recovery Calculations for Foreign Bank Examinations:

Criteria: Section 36a-428*l*, subsection (e), states that a foreign bank, licensed to maintain a branch in the State, shall pay the actual cost of any examination as determined by the Banking Commissioner.

Condition: The Department overcharged two of five foreign banks for the actual costs of examinations in the amount of $4,494, and undercharged one of five for assessment fees in the amount of $16,900. The undercharged assessment was found during our prior audit, but the Department did not consider it in a timely manner for the subsequent billing cycle. The Department's plans are to include the amounts in its billings of foreign banks in December 2010.

Effect: Fees received from foreign banks were not always accurate.

Cause: Errors were made in the calculations of the foreign bank examination costs, and the internal controls did not prevent or detect the errors.

Recommendation: The Department of Banking's Financial Institutions Division should comply with Section 36a-428*l*, subsection (e), improve its internal controls over the calculation of foreign bank examinations, and recover or credit amounts as needed. (See Recommendation 5.)

Agency Response: "The Department of Banking Financial Institutions Division will ensure compliance with Section 36a-428*l*, subsection (e), improve internal controls and recover and/or credit the amounts necessary to address the audit finding. The calculations of the foreign bank examination fees and assessment costs will be fully documented and reflective of the actual cost of the examination pursuant to Section 36a-428*l*, subsection (e). The calculations will be reviewed and approved by the Banking Department Manager and Assistant Division Director who have supervisory oversight of the foreign banks before final submission to the Division Director and Banking Commissioner."

RECOMMENDATIONS

Status of Prior Audit Recommendations:

- We recommended that the Department of Banking design and follow procedures to ensure that accurate receivable balances are reported to the State Comptroller and that write-offs are processed as necessary. During our current audit, we found that there were improvements in the area of receivables; therefore, this recommendation was resolved.

- We recommended that the Department of Banking appropriately design and follow internal controls to ensure that transactions are correctly processed and recorded in the State's records and that the risks of loss are minimized. We found substantial improvements in many of the areas that caused concern during our prior audit; therefore, we are not repeating this recommendation.

Current Audit Recommendations:

1. **The Department of Banking's Financial Institutions Division should adequately follow through on its concerns and document the information necessary to support the sick and compensatory time it grants to employees.**

   Comment:

   One employee was found to have frequent and habitual use of sick time. Two managers earned different amounts of compensatory time, despite taking generally, the same business trip.

2. **The Department of Banking should have procedures in place to monitor compliance with Sections 36a-11 and 36a-12 of the General Statutes.**

   Comment:

   Restrictions on employees' relationships and transactions with the individuals and entities they regulate should be continuously monitored so that conflicts of interests may be minimized or avoided.

3. **The Department of Banking should more carefully assess its needs before making computer-related purchases and should determine how best to document the approval requirements for future software license purchases.**

   Comment:

   It is not appropriate to purchase items that are not used.

4. **The Department of Banking's Consumer Credit Division should seek to obtain and review the audit report on the processes of the outside service organization that it hired to perform revenue collection services and should monitor compliance with other contractual provisions.**

   Comment:

   Generally, SAS 70 reports should be provided by third-party service providers and the Department should monitor the information contained in those reports.

5. **The Department of Banking's Financial Institutions Division should comply with Section 36a-428*l*, subsection (e), improve its internal controls over the calculation of foreign bank examinations, and recover or credit amounts as needed.**

   Comment:

   The Division failed to accurately calculate many inputs to the foreign bank exam calculation, including work days charged, mileage expenses, and training costs.

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, 2008 and 2009. This audit was primarily limited to performing tests of the Agency's compliance with certain provisions of laws, regulations, contracts and grant agreements, 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, contracts and grant agreements applicable to the Agency are complied with, (2) the financial transactions of the Agency are properly initiated, authorized, recorded, processed, and reported on consistent with management's direction, 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, 2008 and 2009, 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 auditing standards generally accepted in the United States of America and the standards applicable to financial 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, contracts and grant agreements 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.

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

In planning and performing our audit, we considered the Department of Banking's internal control over its financial operations, safeguarding of assets, and compliance with requirements as a basis for designing our auditing procedures for the purpose of evaluating the Agency's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grant agreements, but not for the purpose of providing assurance on the effectiveness of the Agency's internal control over those control objectives.

Our consideration of internal control over financial operations, safeguarding of assets, and compliance requirements was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements that might be significant deficiencies or material weaknesses. However as discussed below, we identified certain deficiencies in internal control over financial operations, safeguarding of assets, and compliance with requirements that we consider to be significant deficiencies.

A *control deficie*ncy exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect on a timely basis unauthorized, illegal, or irregular transactions or the breakdown in the safekeeping of any asset or resource. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to properly initiate, authorize, record, process, or report financial data reliably, consistent with management's direction, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts, and grant agreements such that there is more than a remote likelihood that a financial misstatement, unsafe treatment of assets, or noncompliance with laws, regulations, contracts and grant agreements that is more than inconsequential will not be prevented or detected by the Agency's internal control. We consider the following deficiencies described in the accompanying Condition of Records and Recommendations sections of this report to be significant deficiencies in internal control over financial operations, safeguarding of assets and compliance with requirements: Recommendations 1 through 5, to follow through on concerns and documentation for sick and compensatory time granted, to monitor compliance with restriction provisions, to assess more carefully its needs when purchasing computer-related items, to monitor better its third-party service provider, and to calculate accurately the cost of foreign bank examinations.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with certain provisions of laws, regulations, contracts, and grant agreements or the requirements to safeguard assets that would be material in relation to the Agency's financial operations, noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions and material financial misstatements by the Agency being audited will not be prevented or detected by the Agency's internal control.

Our consideration of the internal control over the Agency's financial operations, safeguarding of assets, and compliance with requirements was for the limited purpose described in the first paragraph of this section and would not necessarily disclose all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above are material weaknesses.

We also noted certain matters which we reported to the Agency's management in the accompanying Condition of Records section of this report.

Compliance and Other Matters:

As part of obtaining reasonable assurance about whether the Department of Banking complied with laws, regulations, contracts and grant agreements, 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, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements. However, providing an opinion on compliance with those 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 or other matters that are required to be reported under *Government Auditing Standards.* However, we noted certain matters which we reported to the Agency's management and which are described in the accompanying Condition of Records section of this report.

The Department of Banking's response to the findings identified in our audit is described in the accompanying Condition of Records sections of this report. We did not audit the response and, accordingly, we express no opinion on it.

This report is intended for the information and use of the Agency's management, 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.

Maura F. Pardo
Principal Auditor

Approved:

Robert G. Jaekle
Auditor of Public Accounts

Kevin P. Johnston
Auditor of Public Accounts